ACCA

Applied Skills

Audit and Assurance (AA)

Study Text

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We are here to make a difference to the success of every learner.

Clarity, accessibility and ease of use for our learners are key to our approach.

We will use contemporary examples that are rich, engaging and representative of a diverse workplace.

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It must always be obvious who is being referred to in each stage of any example so that we do not detract from clarity and ease of use for each of our learners.

We will actively seek feedback from our learners on our approach and keep our policy under continuous review. If you would like to provide any feedback on our linguistic approach, please use this form (you will need to enter the link below into your browser).

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We will seek to devise simple measures that can be used by independent assessors to randomly check our success in the implementation of our Linguistic Equality, Diversity and Inclusion Policy.

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These materials are reviewed by the ACCA examining team. The objective of the review is to ensure that the material properly covers the syllabus and study guide outcomes, used by the examining team in setting the exams, in the appropriate breadth and depth. The review does not ensure that every eventuality, combination or application of examinable topics is addressed by the ACCA Approved Content. Nor does the review comprise a detailed technical check of the content as the Approved Content Provider has its own quality assurance processes in place in this respect.

Contents

Introduction

This document references IFRS® Accounting Standards which are authored by the International Accounting Standards Board (the Board), and published in the 2022 IFRS Standards Red Book.

How to use the materials

These Kaplan Publishing learning materials have been carefully designed to make your learning experience as easy as possible and to give you the best chances of success in your examinations.

The product range contains a number of features to help you in the study process. They include:

(1) Detailed study guide and syllabus objectives

(2) Description of the examination

(3) Study skills and revision guidance

(4) Study text

(5) Question practice

The sections on the study guide, the syllabus objectives, the examination and study skills should all be read before you commence your studies. They are designed to familiarise you with the nature and content of the examination and give you tips on how best to approach your learning.

The **Study text** comprises the main learning materials and gives guidance as to the importance of topics and where other related resources can be found. Each chapter includes

- The **learning objectives** contained in each chapter, which have been carefully mapped to the examining body's own syllabus learning objectives or outcomes. You should use these to check you have a clear understanding of all the topics on which you might be assessed in the examination.
- The **chapter diagram** provides a visual reference for the content in the chapter, giving an overview of the topics and how they link together.
- The **content** for each topic area commences with a brief explanation or definition to put the topic into context before covering the topic in detail. You should follow your studying of the content with a review of the illustration/s. These are worked examples which will help you to understand better how to apply the content for the topic.
- **Test your understanding** sections provide an opportunity to assess your understanding of the key topics by applying what you have learned to short questions. Answers can be found at the back of each chapter.
- **Summary diagrams** complete each chapter to show the important links between topics and the overall content of the syllabus. These diagrams should be used to check that you have covered and understood the core topics before moving on.
- **Question practice** is provided at the back of each text.

Quality and accuracy are of the utmost importance to us so if you spot an error in any of our products, please send an email to mykaplanreporting@kaplan.com with full details, or follow the link to the feedback form in MyKaplan.

Our Quality Coordinator will work with our technical team to verify the error and take action to ensure it is corrected in future editions.

Icon Explanations

Supplementary reading – These sections will help to provide a deeper understanding of core areas. The supplementary reading is **NOT** optional reading. It is vital to provide you with the breadth of knowledge you will need to address the wide range of topics within your syllabus that could feature in an exam question. **Reference to this text is vital when self-studying**.

Definition – Key definitions that you will need to learn from the core content.

Key point – Identifies topics that are key to success and are often examined.

Test your understanding – Exercises for you to complete to ensure that you have understood the topics just learned.

Illustration – Worked examples help you understand the core content better.

Tricky topic – When reviewing these areas care should be taken and all illustrations and Test your understanding exercises should be completed to ensure that the topic is understood.

Tutorial note – Included to explain some of the technical points in more detail.

Footsteps – Helpful tutor tips.

Links to other syllabus areas – This symbol refers to areas of interaction with other parts of your syllabus, either in terms of other ACCA papers that you have studied, or may go on to study, or even further professional qualifications that you may decide to pursue on completion of ACCA.

Online subscribers

Our online resources are designed to increase the flexibility of your learning materials and provide you with immediate feedback on how your studies are progressing.

If you are subscribed to our online resources you will find:

(1) Online reference material: reproduces your Study Text online, giving you anytime, anywhere access.

(2) Online testing: provides you with additional online objective testing so you can practice what you have learned further.

(3) Online performance management: immediate access to your online testing results. Review your performance by key topics and chart your achievement through the course relative to your peer group.

Syllabus for September 2023 to June 2024

Syllabus background

The aim of ACCA Audit and Assurance is to develop knowledge and understanding of the process of carrying out the assurance engagement and its application in the context of the professional regulatory framework.

Objectives of the syllabus

- Explain the concept of audit and assurance and the functions of audit, corporate governance, including ethics and professional conduct.
- Demonstrate how the auditor obtains and accepts audit engagements, obtains an understanding of the entity and its environment, assesses the risk of material misstatement (whether arising from fraud or other irregularities) and plans an audit of financial statements.
- Describe and evaluate internal controls, techniques and audit tests, including IT systems to identify and communicate control risks and their potential consequences, making appropriate recommendations. Describe the scope, role and function of internal audit.
- Identify and describe the work and evidence obtained by the auditor and others required to meet the objectives of audit engagements and the application of the International Standards on Auditing (ISAs).
- Explain how consideration of subsequent events and the going concern principle can inform the conclusions from audit work and are reflected in different types of auditor's report, written representations and the final review and report.
- Demonstrate employability and technology skills.

Core areas of the syllabus

- Audit framework and regulation.
- Planning and risk assessment.
- Internal control.
- Audit evidence.
- Review and reporting.
- Employability and technology skills.

ACCA Performance Objectives

In order to become a member of the ACCA, as a trainee accountant you will need to demonstrate that you have achieved nine performance objectives. Performance objectives are indicators of effective performance and set the minimum standard of work that trainees are expected to achieve and demonstrate in the workplace. They are divided into key areas of knowledge which are closely linked to the exam syllabus.

There are five Essential performance objectives and a choice of fifteen Technical performance objectives which are divided into five areas.

The performance objectives which link to this exam are:

(1) Ethics and professionalism (Essential)

(2) Governance risk and control (Essential)

(3) Prepare for and plan the audit and assurance process (Technical)

(4) Collect and evaluate evidence for an audit or assurance engagement (Technical)

(5) Review and report on the findings of an audit or assurance engagement (Technical)

The following link provides an in depth insight into all of the performance objectives:

https://www.accaglobal.com/content/dam/ACCA_Global/Students/per/PER-Performance-objectives-achieve.pdf

Progression

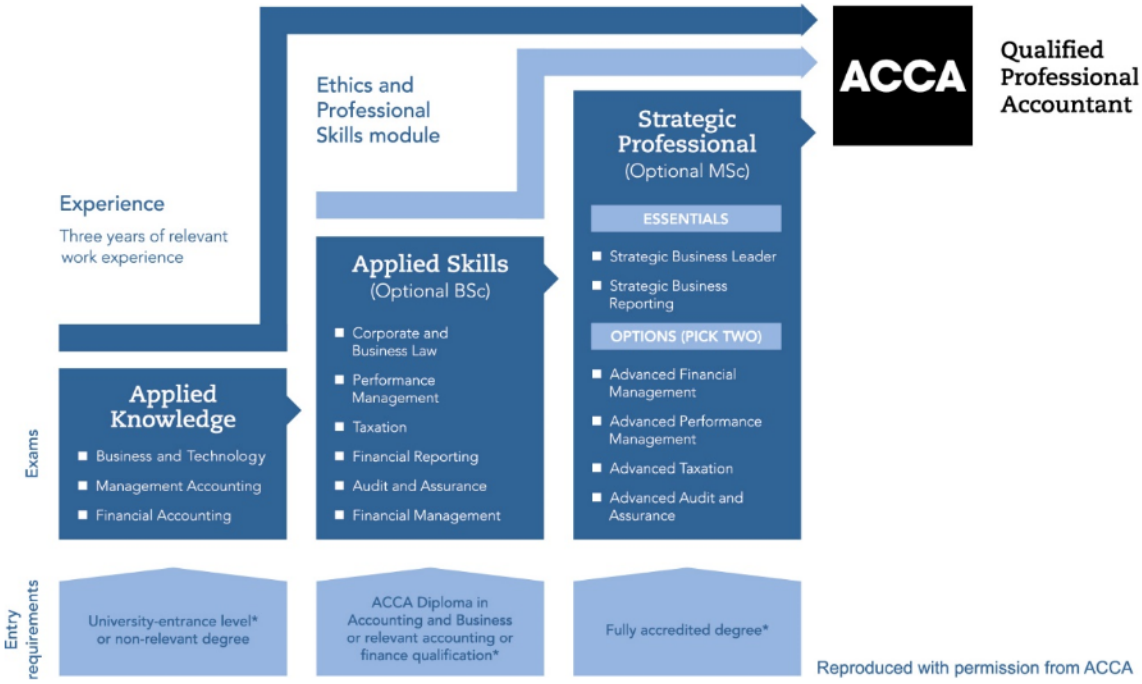
There are two elements of progression that we can measure: first how quickly students move through individual topics within a subject; and second how quickly they move from one course to the next. We know that there is an optimum for both, but it can vary from subject to subject and from student to student. However, using data and our experience of student performance over many years, we can make some generalisations.

A fixed period of study set out at the start of a course with key milestones is important. This can be within a subject, for example 'I will finish this topic by 30 June', or for overall achievement, such as 'I want to be qualified by the end of next year'.

Your qualification is cumulative, as earlier papers provide a foundation for your subsequent studies, so do not allow there to be too big a gap between one subject and another. We know that exams encourage techniques that lead to some degree of short-term retention, the result being that you will simply forget much of what you have already learned unless it is refreshed (look up Ebbinghaus Forgetting Curve for more details on this). This makes it more difficult as you move from one subject to another: not only will you have to learn the new subject, you will also have to relearn all the underpinning knowledge as well. This is very inefficient and slows down your overall progression which makes it more likely you may not succeed at all.

In addition, delaying your studies slows your path to qualification which can have negative impacts on your career, postponing the opportunity to apply for higher level positions and therefore higher pay.

You can use the following diagram showing the whole structure of your qualification to help you keep track of your progress.



Reproduced with permission from ACCA

Syllabus objectives and chapter references

We have reproduced the ACCA's syllabus below, showing where the objectives are explored within this book. Within the chapters, we have broken down the extensive information found in the syllabus into easily digestible and relevant sections, called Content Objectives. These correspond to the objectives at the beginning of each chapter.

Syllabus learning objective	Chapter reference
A AUDIT FRAMEWORK AND REGULATION	
1 The concept of audit and other assurance engagements	
(a) Identify and describe the objective and general principles of external audit engagements. [2]	1
(b) Explain the nature and development of audit and other assurance engagements. [1]	1
(c) Discuss the concepts of accountability, stewardship and agency. [2]	1
(d) Define and provide the objectives of an assurance engagement. [1]	1
(e) Explain the five elements of an assurance engagement. [2]	1
(f) Describe the types of assurance engagement. [2]	1
(g) Explain the level of assurance provided by an external audit and other review engagements and the concept of true and fair presentation. [1]	1
2 External audits	
(a) Describe the regulatory environment within which external audits take place. [1]	2
(b) Discuss the reasons and mechanisms for the regulation of auditors. [1]	2
(c) Explain the statutory regulations governing the appointment, rights, removal and resignation of auditors. [1]	2
(d) Explain the regulations governing the rights and duties of auditors. [1]	2
(e) Describe the limitations of external audits. [1]	1
(f) Explain the development and status of International Standards on Auditing (ISAs). [1]	2
(g) Explain the relationship between International Standards on Auditing and national standards. [1]	2

Syllabus learning objective			Chapter reference
3	**Corporate governance**		
	(a)	Discuss the objectives, relevance and importance of corporate governance. [2]	3
	(b)	Discuss the provisions of international codes of corporate governance (such as OECD) that are most relevant to auditors. [2]	3
	(c)	Describe good corporate governance requirements relating to directors' responsibilities (e.g. for risk management and internal control) and the reporting responsibilities of auditors. [2]	3
	(d)	Evaluate corporate governance deficiencies and provide recommendations to allow compliance with international codes of corporate governance. [2]	3
	(e)	Analyse the structure and roles of audit committees and discuss their benefits and limitations. [2]	3
	(f)	Explain the importance of internal control and risk management. [1]	3
4	**Professional ethics and ACCA's Code of Ethics and Conduct**		
	(a)	Define and apply the fundamental principles of professional ethics of integrity, objectivity, professional competence and due care, confidentiality and professional behaviour. [2]	4
	(b)	Define and apply the conceptual framework, including the threats to the fundamental principles of self-interest, self-review, advocacy, familiarity, and intimidation. [2]	4
	(c)	Discuss the safeguards to offset the threats to the fundamental principles. [2]	4
	(d)	Describe the auditor's responsibility with regard to auditor independence, conflicts of interest and confidentiality. [1]	4
B	**PLANNING AND RISK ASSESSMENT**		
1	**Obtaining, accepting and continuing audit engagements**		
	(a)	Discuss the requirements of professional ethics and ISAs in relation to the acceptance/continuance of audit engagements. [2]	4
	(b)	Explain the preconditions for an audit. [2]	4
	(c)	Explain the process by which an auditor obtains an audit engagement. [2]	4

Syllabus learning objective			Chapter reference
	(d)	Discuss the importance and purpose of engagement letters and their contents. [1]	4
	(e)	Explain the overall objectives and importance of quality management procedures in conducting an audit. [2]	6
	(f)	Explain the quality management procedures which should be in place over engagement resources, engagement performance, monitoring and remediation and compliance with ethical requirements. [2]	6
	(g)	Evaluate quality management deficiencies and provide recommendations to allow compliance with quality management requirements. [2]	6
2	**Objective and general principles**		
	(a)	Identify the overall objectives of the auditor and the need to conduct an audit in accordance with ISAs. [2]	1 & 6
	(b)	Explain the need to plan and perform audit engagements with an attitude of professional scepticism, and to exercise professional judgement. [2]	5
3	**Assessing audit risks**		
	(a)	Explain the components of audit risk. [1]	5
	(b)	Describe the audit risks in the financial statements and explain the auditor's response to each risk. [2]	5
	(c)	Define and explain the concepts of materiality and performance materiality. [2]	5
	(d)	Explain and calculate materiality levels from financial information. [2]	5
4	**Understanding the entity, its environment and the applicable financial reporting framework**		
	(a)	Explain how auditors obtain an initial understanding of the entity, its environment and the applicable financial reporting framework. [2]	5
	(b)	Describe and explain the nature and purpose of analytical procedures in planning. [2]	5
	(c)	Compute and interpret key ratios used in analytical procedures. [2]	5

Syllabus learning objective			Chapter reference
5	**Fraud, laws and regulations**		
	(a)	Discuss the effect of fraud and misstatements on the audit strategy and extent of audit work. [2]	6
	(b)	Discuss the responsibilities of internal and external auditors for the prevention and detection of fraud and error. [2]	6
	(c)	Explain the auditor's responsibility to consider laws and regulations. [2]	6
6	**Audit planning and documentation**		
	(a)	Identify and explain the need for, benefits of and importance of planning an audit. [2]	6
	(b)	Identify and describe the contents of the overall audit strategy and audit plan. [2]	6
	(c)	Explain and describe the relationship between the overall audit strategy and the audit plan. [2]	6
	(d)	Explain the difference between interim and final audit. [1]	6
	(e)	Describe the purpose of an interim audit, and the procedures likely to be adopted at this stage in the audit. [2]	6
	(f)	Describe the impact of the work performed during the interim audit on the final audit. [2]	6
	(g)	Explain the need for, and the importance of, audit documentation. [1]	6
	(h)	Describe the form and contents of working papers and supporting documentation. [2]	6
	(i)	Explain the procedures to ensure safe custody and retention of working papers. [1]	6
C	**INTERNAL CONTROL**		
1	**Systems of internal control**		
	(a)	Explain why an auditor needs to obtain an understanding of the components of internal control relevant to the preparation of the financial statements. [1]	8
	(b)	Describe and explain the five components of internal control. [2]	8
		(i) the control environment	
		(ii) the entity's risk assessment process	

Syllabus learning objective			Chapter reference
		(iii) the entity's process to monitor the system of internal control	
		(iv) the information system and communication	
		(v) control activities.	
2	**The use and evaluation of systems of internal control by auditors**		
	(a)	Explain how auditors record systems of internal control including the use of narrative notes, flowcharts and questionnaires. [2]	8
	(b)	Evaluate internal control components, including deficiencies and significant deficiencies in internal control. [2]	8
	(c)	Discuss the limitations of internal control components. [2]	8
3	**Tests of controls**		
	(a)	Describe computer systems controls including general IT controls and information processing controls. [2]	8
	(b)	Describe control objectives, control procedures, control activities, direct controls, indirect controls and tests of control in relation to:	8
		(i) The sales system	
		(ii) The purchases system	
		(iii) The payroll system	
		(iv) The inventory system	
		(v) The bank and cash system	
		(vi) Non-current assets.	
4	**Communication on internal control**		
	(a)	Discuss the requirements and methods of how reporting significant deficiencies in internal control are provided to management and those charged with governance. [2]	8
	(b)	Explain, in a format suitable for inclusion in a report to management, significant deficiencies within a system of internal control and provide control recommendations for overcoming these deficiencies to management. [2]	8
	(c)	Discuss the need for auditors to communicate with those charged with governance. [2]	8 & 12

Syllabus learning objective	Chapter reference
5 Internal audit and governance, and the differences between external audit and internal audit	
(a) Discuss the factors to be taken into account when assessing the need for internal audit. [2]	9
(b) Discuss the elements of best practice in the structure and operations of internal audit. [2]	9
(c) Compare and contrast the role of external and internal audit. [2]	9
6 The scope of the internal audit function, outsourcing and internal audit assignments	
(a) Discuss the scope of internal audit and the limitations of the internal audit function. [2]	9
(b) Explain outsourcing and the associated advantages and disadvantages of outsourcing the internal audit function. [1]	9
(c) Discuss the nature and purpose of internal audit assignments including value for money, IT, financial, regulatory compliance, fraud investigations and customer experience. [2]	9
(d) Discuss the nature and purpose of operational internal audit assignments. [2]	9
(e) Describe the format and content of internal audit review reports and make appropriate recommendations to management and those charged with governance. [2]	9
D AUDIT EVIDENCE	
1 Assertions and audit evidence	
(a) Explain the assertions contained in the financial statements about: [2]	7
(i) Classes of transactions and events and related disclosures	
(ii) Account balances and related disclosures at the period end.	
(b) Describe audit procedures to obtain audit evidence, including inspection, observation, external confirmation, recalculation, re-performance, analytical procedures and enquiry. [2]	7

Syllabus learning objective	Chapter reference
(c) Discuss the quality and quantity of audit evidence. [2]	7
(d) Discuss the relevance and reliability of audit evidence. [2]	7
2 Audit procedures	
(a) Discuss substantive procedures for obtaining audit evidence. [2]	7
(b) Discuss and provide examples of how analytical procedures are used as substantive procedures. [2]	7
(c) Discuss the problems associated with the audit and review of accounting estimates. [2]	10
(d) Describe why smaller entities may have different control environments and describe the types of evidence likely to be available in smaller entities. [1]	10
(e) Discuss the difference between tests of control and substantive procedures. [2]	7
3 Audit sampling and other means of testing	
(a) Define audit sampling and explain the need for sampling. [1]	7
(b) Identify and discuss the differences between statistical and non-statistical sampling. [2]	7
(c) Discuss and provide relevant examples of, the application of the basic principles of statistical sampling and other selective testing procedures. [2]	7
(d) Discuss the results of statistical sampling, including consideration of whether additional testing is required. [2]	7
4 The audit of specific items	
For each of the account balances stated in this sub-capability:	
Explain the audit objectives and the audit procedures to obtain sufficient, appropriate evidence in relation to:	
(a) Receivables: [2]	10
(i) direct confirmation of accounts receivable	
(ii) other evidence in relation to receivables and prepayments	
(iii) other evidence in relation to current assets	
(iv) completeness and occurrence of revenue.	

Syllabus learning objective			Chapter reference
(b)	Inventory: [2]		10
	(i)	inventory counting procedures in relation to year-end and continuous inventory systems	
	(ii)	cut-off testing	
	(iii)	auditor's attendance at inventory counting	
	(iv)	direct confirmation of inventory held by third parties	
	(v)	valuation	
	(vi)	other evidence in relation to inventory.	
(c)	Payables and accruals: [2]		10
	(i)	supplier statement reconciliations and direct confirmation of accounts payable	
	(ii)	obtain evidence in relation to payables and accruals	
	(iii)	other evidence in relation to current liabilities	
	(iv)	purchases and other expenses, including payroll.	
(d)	Bank and cash: [2]		10
	(i)	bank confirmation reports used in obtaining evidence in relation to bank and cash	
	(ii)	other evidence in relation to bank	
	(iii)	other evidence in relation to cash.	
(e)	Tangible and intangible non-current assets: [2]		10
	(i)	evidence in relation to non-current assets	
	(ii)	depreciation	
	(iii)	profit/loss on disposal.	
(f)	Non-current liabilities, provisions and contingencies: [2]		10
	(i)	evidence in relation to non-current liabilities	
	(ii)	provisions and contingencies.	
(g)	Share capital, reserves and directors' emoluments: [2]		10
	(i)	evidence in relation to share capital, reserves and directors' emoluments.	

Syllabus learning objective			Chapter reference
5	**Automated tools and techniques**		
	(a)	Explain the use of automated tools and techniques in the context of an audit, including the use of audit software, test data and other data analytics tools. [1]	7
	(b)	Discuss and provide relevant examples of the use of automated tools and techniques including test data, audit software and other data analytics tools. [2]	7
6	**The work of others**		
	(a)	Discuss why auditors rely on the work of others. [2]	7
	(b)	Discuss the extent to which external auditors are able to rely on the work of experts, including the work of internal audit. [2]	7
	(c)	Explain the audit considerations relating to entities using service organisations. [2]	7
	(d)	Explain the extent to which reference to the work of others can be made in the independent auditor's report. [1]	7
7	**Not-for-profit organisations**		
	(a)	Apply audit techniques to not-for-profit organisations. [2]	10
E	**REVIEW AND REPORTING**		
1	**Subsequent events**		
	(a)	Explain the purpose of a subsequent events review. [1]	11
	(b)	Explain the responsibilities of auditors regarding subsequent events. [1]	11
	(c)	Discuss the procedures to be undertaken in performing a subsequent events review. [2]	11
2	**Going concern**		
	(a)	Define and discuss the significance of the concept of going concern. [2]	11
	(b)	Explain the importance of and the need for going concern reviews. [2]	11
	(c)	Explain the respective responsibilities of auditors and management regarding going concern. [1]	11
	(d)	Identify and explain potential indicators that an entity is not a going concern. [2]	11
	(e)	Discuss the procedures to be applied in performing going concern reviews. [2]	11

Syllabus learning objective			Chapter reference
	(f)	Discuss the disclosure requirements in relation to going concern issues. [2]	11
	(g)	Discuss the reporting implications of the findings of going concern reviews. [2]	11
3	**Written representations**		
	(a)	Explain the purpose of and procedure for obtaining written representations. [2]	11
	(b)	Discuss the quality and reliability of written representations as audit evidence. [2]	11
	(c)	Discuss the circumstances where written representations are necessary and the matters on which representations are commonly obtained. [2]	11
4	**Audit finalisation and the final review**		
	(a)	Discuss the importance of the overall review in ensuring that sufficient, appropriate evidence has been obtained. [2]	11
	(b)	Describe procedures an auditor should perform in conducting their overall review of financial statements. [2]	11
	(c)	Explain the significance of uncorrected misstatements. [1]	11
	(d)	Evaluate the effect of dealing with uncorrected misstatements. [2]	11
5	**The Independent Auditor's Report**		
	(a)	Identify and describe the basic elements contained in the independent auditor's report. [1]	12
	(b)	Explain unmodified audit opinions in the auditor's report. [2]	12
	(c)	Explain the circumstances in which a modified audit opinion may be issued in the auditor's report. [2]	12
	(d)	Explain the impact on the auditor's report when a modified opinion is issued. [2]	12
	(e)	Describe the format and content of key audit matters, emphasis of matter and other matter paragraphs. [2]	12

Syllabus learning objective			Chapter reference
F	**Employability and technology skills**		
	1	Use computer technology to efficiently access and manipulate relevant information.	13
	2	Work on relevant response options, using available functions and technology, as requirements, using the appropriate tools.	13
	3	Navigate windows and computer screens to create and amend responses to exam requirements, using the appropriate tools.	13
	4	Present data and information effectively, using the appropriate tools.	13

The superscript numbers in square brackets indicate the intellectual depth at which the subject area could be assessed within the examination. Level 1 (knowledge and comprehension) broadly equates with the Knowledge module, Level 2 (application and analysis) with the Skills module and Level 3 (synthesis and evaluation) to the Professional level. However, lower level skills can continue to be assessed as you progress through each module and level.

References to ISA paragraph numbers within the study text are for copyright purposes only. Students are not required to learn this level of detail.

For a list of examinable documents, see the ACCA website:

accaglobal.com/audit-and-assurance

The Examination

Examination format

The syllabus is assessed by computer-based examination (CBE).

The CBE will contain 100 marks of exam content that needs to be completed within 3 hours. Prior to the start of the exam candidates are given an extra 10 minutes to read the exam instructions.

All questions are compulsory. The exam will contain both computational and discursive elements.

Some questions will adopt a scenario/case study approach.

The pass mark is 50%.

All questions follow a dating convention whereby the 'current date' is set at 1 July 20X5. This information will be stated in the question where relevant. Year-end dates of the entity being audited will then be flexed appropriately around this. For example, in a planning question the entity could have a year end of 31 August 20X5. In an audit evidence/reporting question the year end could be 31 March 20X5. The application of this consistent dating convention allows candidates to be able to quickly determine where they are in the audit process.

Section A

Section A of the exam comprises three 10-mark case-based questions. Each case has five objective test questions worth 2 marks each.

There are no dependencies between the individual questions. Therefore, if you get one question wrong, it will not affect your ability to get the others correct.

OT questions in section A will be of varying styles as follows:

- Multiple choice – where you are required to choose one answer from a list of options provided by clicking on the appropriate 'radio button'.
- Multiple response – where you are required to select more than one response from the options provided by clicking on the appropriate tick boxes. The question will specify how many answers need to be selected, but the system won't stop you from selecting more answers than this.
- Fill in the blank – where you are required to type an answer into a box (usually numerical, but may be text). Any specific rounding requirements will be displayed.
- Drag and drop – where you are required to drag an answer and drop it into place. Some questions could involve matching more than one answer to a response area and some questions may have more answer choices than response areas, which means not all available answer choices need to be used.
- Drop down list – where you are required to select one answer from a drop-down list. Some questions may contain more than one drop-down list and an answer has to be selected from each one.

- Hot spot – where you are required to select one point on an image as your answer. When the cursor is hovered over the image, it will display as an 'X'. To answer, place the X on the appropriate point on the diagram.
- Hot area – these are similar to hot spot questions, but instead of selecting a specific point, you are required to select one or more areas in an image.

Section B

Section B of the exam comprises one 30 mark question and two 20 mark questions.

This section of the exam will predominantly examine one or more aspects of audit and assurance from planning and risk assessment, internal control or audit evidence, although topics from other syllabus areas may also be included.

Examination tips

Be sure you understand how to use the software before you start the exam. If in doubt, ask the assessment centre staff to explain it to you.

Questions are displayed on the screen and answers are entered using keyboard and mouse.

We recommend that 10 minutes should be spent reviewing the format and content of the requirements so that you understand what you need to do. Pay particular attention to section B, where questions will be based on longer scenarios than the 2 mark OT cases in section A.

Read each question carefully.

- Divide the time you spend on questions in proportion to the marks on offer.
- One suggestion for this examination is to allocate 1.8 minutes to each mark available (180 minutes/100 marks), so a 20 mark question should be completed in approximately 36 minutes.

Section A

You should begin by reading the OT questions that relate to the case, so that when you read through the information for the first time, you know what it is that you are required to do.

Once you have read through the information, you should first answer any of the OT questions that can be quickly answered. You should then attempt the other OT questions utilising the remaining time for that case.

If you don't know the answer, eliminate those options you know are incorrect and see if the answer becomes more obvious. After you have eliminated the options that you know to be wrong, if you are still unsure, guess.

Answer every question.

Each OT question is worth two marks. Therefore, you have 18 minutes (1.8 minutes per mark) to answer the five OT questions relating to each case. It is likely that all of the cases will take the same length of time to answer, although some of the OT questions within a case may be quicker than other OT questions within that same case.

Work steadily. Rushing leads to careless mistakes and the OT questions are designed to include answers which result from careless mistakes.

Section A questions can be found at the end of each chapter.

Section B

The constructed response questions in section B will require a written response rather than being OT questions. Therefore, different techniques need to be used to score well.

Unless you know exactly how to answer the question, spend some time planning your answer. Stick to the question and tailor your answer to what you are asked. Pay particular attention to the verbs in the question e.g. 'Describe', 'State', 'Explain'.

If you get completely stuck with a question leave it and return to it later.

If you do not understand what a question is asking, state your assumptions. Even if you do not answer in precisely the way the examining team hoped, you may be given some credit, provided that your assumptions are reasonable.

When answering the constructed response questions, be concise. DO NOT write an essay.

Make sure that each point is clearly identifiable by leaving a line space between each of your points.

Some questions ask you to present your answer in the form of a report or letter. Use the correct format as there are easy marks to gain here for presentation.

Guidance on exam technique for the constructed response questions is given in the relevant chapters of the study text.

Section B style questions can be found in most chapters and also in the chapter ‘Questions and Answers’.

All sections

Don’t skip parts of the syllabus. The AA syllabus has 18 different questions so the examination can cover a very broad selection of the syllabus each sitting.

Spend time learning definitions.

Practice plenty of questions to improve your ability to apply the techniques.

Spend the last few minutes reading through your answers and making any additions or corrections.

Don't panic if you realise you've answered a question incorrectly. Try to remain calm, continue to apply examination technique and answer all questions required within the time available.

ACCA support

For additional support with your studies please also refer to the ACCA Global website.

Study skills and revision guidance

This section aims to give guidance on how to study for your ACCA exams and to give ideas on how to improve your existing study techniques.

Preparing to study

Set your objectives

Before starting to study decide what you want to achieve i.e. the type of pass you wish to obtain. This will decide the level of commitment and time you need to dedicate to your studies.

Devise a study plan

Determine which times of the week you will study.

Split these times into sessions of at least one hour for study of new material. Any shorter periods could be used for revision or practice.

Put the times you plan to study onto a study plan for the weeks from now until the exam and set yourself targets for each period of study. In your sessions make sure you cover the course, course assignments and revision.

If you are studying for more than one exam at a time, try to vary your subjects as this can help you to keep interested and see subjects as part of wider knowledge.

When working through your course, compare your progress with your plan and, if necessary, re-plan your work (perhaps including extra sessions) or, if you are ahead, do some extra revision/practice questions.

Effective studying

Active reading

You are not expected to learn the text by rote, rather, you must understand what you are reading and be able to use it to pass the exam and develop good practice. A good technique to use is SQ3Rs – Survey, Question, Read, Recall, Review:

(1) **Survey the chapter** – look at the headings and read the introduction, summary and objectives, to get an overview of what the chapter deals with.

(2) **Question** – whilst undertaking the survey, ask yourself the questions that you hope the chapter will answer for you.

(3) **Read** through the chapter thoroughly, answering the questions and making sure you can meet the objectives. Attempt the exercises and activities in the text, and work through all the examples.

(4) **Recall** – at the end of each section and at the end of the chapter, try to recall the main ideas of the section/chapter without referring to the text. This is best done after a short break of a couple of minutes after the reading stage.

(5) **Review** – check that your recall notes are correct.

You may also find it helpful to re-read the chapter to try to see the topic(s) it deals with as a whole.

Note-taking

Taking notes is a useful way of learning, but do not simply copy out the text. The notes must:

- be in your own words
- be concise
- cover the key points
- be well-organised
- be modified as you study further chapters in this text or in related ones.

Trying to summarise a chapter without referring to the text can be a useful way of determining which areas you know and which you don't.

Summarise the key points of a chapter.

Three ways of taking notes:

(1) **Make linear notes** – a list of headings, divided up with subheadings listing the key points. If you use linear notes, you can use different colours to highlight key points and keep topic areas together. Use plenty of space to make your notes easy to use.

(2) **Try a diagrammatic form** – the most common of which is a mind-map. To make a mind-map, put the main heading in the centre of the paper and put a circle around it. Then draw short lines radiating from this to the main subheadings, which again have circles around them. Then continue the process from the sub-headings to sub-sub-headings, advantages, disadvantages, etc.

(3) **Highlighting and underlining** – you may find it useful to underline or highlight key points in your study text – but do be selective. You may also wish to make notes in the margins.

Revision

The best approach to revision is to revise the course as you work through it. Also try to leave four to six weeks before the exam for final revision. Make sure you cover the whole syllabus and pay special attention to those areas where your knowledge is weak. Here are some recommendations:

Read through the text and your notes again and condense your notes into key phrases. It may help to put key revision points onto index cards to look at when you have a few minutes to spare.

Review any assignments you have completed and look at where you lost marks – put more work into those areas where you were weak.

Practise exam standard questions under timed conditions. If you are short of time, list the points that you would cover in your answer and then read the model answer, but do try to complete at least a few questions under exam conditions.

Also practise producing answer plans and comparing them to the model answer.

If you are stuck on a topic find somebody (a tutor) to explain it to you.

Read good newspapers and professional journals, especially ACCA's **Student Accountant**, this can give you an advantage in the exam.

Ensure you **know the structure of the exam** – how many questions and of what type you will be expected to answer.

During your revision attempt all the different styles of questions you may be asked.

Further reading

You can find further reading and technical articles under the student section of ACCA's website.

Technical update

This text has been updated to reflect Examinable Documents September 2023 to June 2024 issued by ACCA.

Chapter

1

Introduction to assurance

Chapter learning objectives

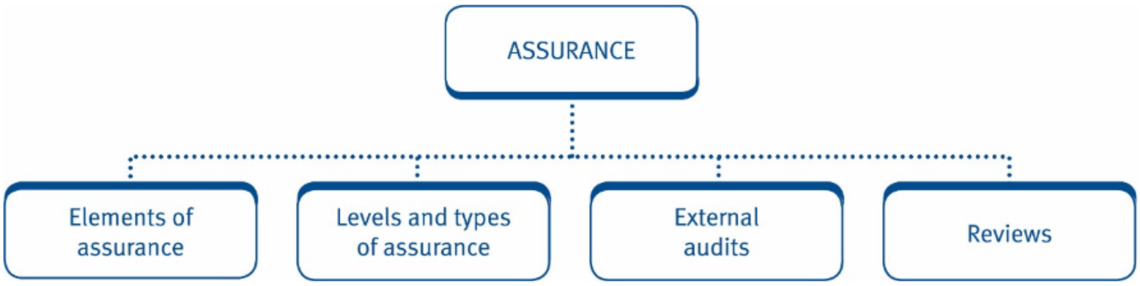
This chapter covers syllabus areas:

- A1 – The concept of audit and other assurance engagements
- A2e – Limitations of external audits

Detailed syllabus objectives are provided in the introduction section of the text book.

PER

One of the PER performance objectives (PO4) is governance risk and control. You contribute to effective governance in your area. You evaluate, monitor and implement risk management procedures, complying with the spirit and the letter of policies, laws and regulations. Working through this chapter should help you understand how to demonstrate that objective.



1 What is assurance?

An assurance engagement is: 'An engagement in which a practitioner obtains sufficient appropriate evidence in order to express a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.'

[International Framework for Assurance Engagements, 7]

Giving assurance means offering an opinion about specific information so the users of that information are able to make **confident decisions** knowing that the **risk** of the information being 'incorrect' is **reduced**.

Elements of an assurance engagement

There are **five elements of an assurance engagement**:

1 **Three party involvement**

   Practitioner – the reviewer of the subject matter who provides the assurance.

   Intended users – the people using the subject matter to make economic decisions.

   Responsible party – the party responsible for preparing the subject matter.

2 **Appropriate subject matter**

   The information subject to examination by the practitioner.

3 **Suitable criteria**

   The criteria against which the subject matter is evaluated, i.e. standards, guidance, laws and regulations.

4 **Sufficient appropriate evidence**

   Sufficient appropriate evidence is needed to provide a basis for the opinion/ conclusion.

5 **Written assurance report** in an appropriate form

   The output of the assurance engagement expressing a conclusion/opinion about the subject matter.

[International Framework for Assurance Engagements, 20]

	Element	In relation to an audit	In relation to a forecast
1	Three party involvement		
	Practitioner	Auditor	Assurance provider
	Intended user	Shareholders	Directors/provider of finance
	Responsible party	Directors	Directors
2	Appropriate subject matter	Financial statements	Forecast
3	Suitable criteria	Financial reporting framework	Appropriate assumptions and financial reporting framework
4	Sufficient appropriate evidence	Obtained by performing audit procedures such as tests of controls, tests of detail and analytical procedures	Obtained by performing examination procedures such as inspection of documents, enquiries and analytical procedures
5	Written assurance report in an appropriate form	Independent auditor's report providing an opinion as to whether the financial statements give a true and fair view	Independent assurance report providing a conclusion on whether anything has come to the practitioner's attention to suggest the assumptions are not a reasonable basis for the forecast, and an opinion on whether the forecast has been prepared on the basis of those assumptions

Illustration 1 – Buying a house

Consider someone who is buying a house. There is a risk that the buyer pays a large sum of money to purchase a structurally unsafe property which needs further expenditure to make it habitable. To reduce this risk, it is normal for house buyers (the users) to pay a property surveyor (the practitioner) to perform a structural assessment of the house (the subject matter). The surveyor communicates any structural deficiencies identified (measured against building regulations/best practice and other criteria) in a written report to the house buyer. With this information, the potential buyer can make a decision whether or not to buy the house with the confidence that they know its structural condition. In this example, the responsible party is the current house owner, and the evidence would be obtained through visual inspection of the property.

Assurance engagements

Examples of assurance engagements include:

- Audit of financial statements
- Review of financial statements
- Systems reliability reports
- Verification of social and environmental information
- Review of internal controls
- Value for money audit in public sector organisations.

General principles the assurance provider must follow when performing such engagements include:

- Comply with ethical requirements.
- Apply professional scepticism and judgement.
- Perform acceptance and continuance procedures to ensure only work of acceptable risk is accepted.
- Agree the terms of engagement.
- Comply with quality management standards.
- Plan and perform the engagement effectively.
- Obtain sufficient and appropriate evidence.
- Consider the effect of subsequent events on the subject matter.
- Form a conclusion expressing either reasonable or limited assurance as appropriate.
- Document the evidence to provide a record of the basis for the assurance report.

Types of assurance engagement

Two types of assurance engagement are permitted:

Reasonable assurance engagements	Limited assurance engagements
The practitioner:	The practitioner:
Gathers **sufficient appropriate evidence** to be able to draw **reasonable conclusions**.	Gathers **sufficient appropriate evidence** to be able to draw **limited conclusions**.
Performs very thorough procedures to obtain sufficient appropriate evidence including tests of controls and substantive procedures.	Performs significantly fewer procedures, mainly enquiries and analytical procedures.
Concludes that the subject matter **conforms in all material respects** with identified suitable criteria.	Concludes that the subject matter, with respect to identified suitable criteria, is **plausible in the circumstances**.
Gives a **positively** worded assurance **opinion**.	Gives a **negatively** worded assurance **conclusion**.
Gives a **high level** of assurance (confidence).	Gives a **moderate or lower level** of assurance than that of an audit.
In our opinion, the financial statements give a true and fair view of (or *present fairly, in all material respects*) the financial position of Murray Company as at December 31, 20X4, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.	**Nothing has come to our attention** that causes us to believe that the financial statements of Murray Company as of 31 December, 20X4 are not prepared, in all material respects, in accordance with an applicable financial reporting framework.

The confidence inspired by a reasonable assurance report is designed to be greater than that inspired by a limited assurance report. Therefore:

- There are more regulations/standards governing a reasonable assurance assignment.
- The procedures carried out in a reasonable assurance assignment will be more thorough.
- The evidence gathered will need to be of a higher quality.

2 External audit engagements

An external audit is an example of a **reasonable assurance** engagement.

Purpose of an external audit engagement

ISA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing* states the purpose of an external audit engagement is to **'enhance the degree of confidence of intended users in the financial statements.'**

This is achieved by the auditor expressing an opinion on whether the financial statements:

- Give a true and fair view (or present fairly in all material respects).
- Are prepared, in all material respects, in accordance with an applicable financial reporting framework.

[ISA 200, 3]

The financial reporting framework to be applied will vary from country to country. In Audit & Assurance, it is assumed that International Financial Reporting Standards are the basis for preparing the financial statements.

The accounting standards examinable for Audit & Assurance are those from Financial Accounting at the Applied Knowledge level.

True and fair

- **True:** factually correct information which conforms with accounting standards and relevant legislation, and agrees with the underlying records.
- **Fair:** clear, impartial and unbiased information which reflects the commercial substance of the transactions of the entity.

Objectives of the auditor

The objectives of an **auditor** are to:

- Obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.
- Express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.
- Report on the financial statements, and communicate as required by ISAs, in accordance with the auditor's findings.

[ISA 200, 11]

Need for external audit

- Shareholders provide the finance for a company and may or may not be involved in the day to day running of the company.
- Directors manage the company on behalf of the shareholders in order to achieve the objectives of that company (normally the maximisation of shareholder wealth).
- The directors must prepare financial statements to provide information on performance and financial position to the shareholders.
- The directors have various incentives to manipulate the financial statements and show a different level of performance.
- Hence the need for an independent review of the financial statements to ensure they give a true and fair view – the external audit.

In most developed countries, publicly quoted companies and large companies are required by law to produce annual financial statements and have them audited by an external auditor.

Companies that are not required to have a statutory audit may choose to have an external audit because the company's shareholders or other influential stakeholders want one, and because of the benefits of an audit.

Benefits of an audit

- **H**igher quality information which is more reliable, improving the reputation of the market.
- **I**ndependent scrutiny and verification may be valuable to management.
- **R**educes the risk of management bias and fraud and error by acting as a deterrent. An audit may also detect bias, fraud and error.
- **E**nhances the credibility of the financial statements, e.g. for tax authorities or lenders.
- **D**eficiencies in the internal control system may be highlighted by the auditor.

Expectation gap

Some users incorrectly believe that an audit provides absolute assurance – that the audit opinion is a guarantee the financial statements are 'correct'. This and other misconceptions about the role of an auditor are referred to as the **'expectation gap'**.

Examples of the expectation gap

- A belief that the auditor tests **all** transactions and balances – tests are performed on a sample basis.
- A belief that the auditor will detect **all** fraud – the auditor is required to provide reasonable assurance that the financial statements are free from **material** misstatement, which may be caused by fraud.
- A belief that the auditor is responsible for **preparing** the financial statements – this is the responsibility of management.

Limitations of an audit

- **F**inancial statements include subjective estimates and other judgemental matters.
- **I**nternal controls may be relied on which have their own inherent limitations.
- **R**epresentations from management may have to be relied upon as the only source of evidence in some areas.
- **E**vidence is often persuasive not conclusive.
- **D**o not test all transactions and balances, only a sample are tested.

The auditor provides reasonable assurance which is not absolute assurance. The **limitations of an audit** mean that it is not possible to provide a 100% guarantee of accuracy.

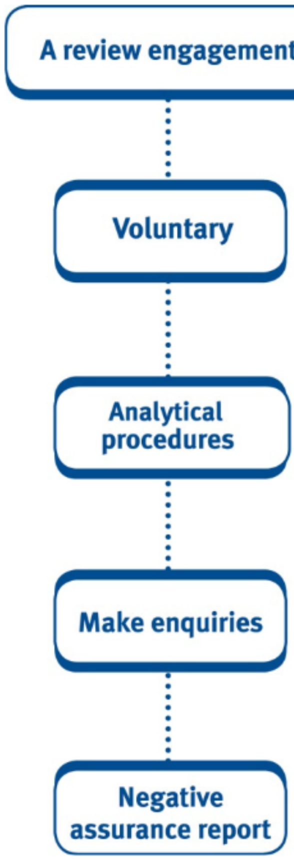
Limitations of an audit

- Nature of financial reporting – financial statement amounts are affected by management judgement and therefore subject to bias.
- Nature of audit procedures – information provided by the client may be incomplete or falsified documents may be provided.
- Timeliness of financial reporting – the relevance of information diminishes over time and the auditor cannot investigate every matter exhaustively.

[ISA 200, A48 – A50]

3 Review engagements

A review engagement is an example of a **limited assurance** engagement.



Purpose and objective of a review engagement

A company which is not legally required to have an audit may choose to have a review of its financial statements instead. The review will still provide some assurance to users but is likely to cost less and be less disruptive than an audit.

The procedures will mainly focus on analytical procedures and enquiries of management. In particular, no tests of controls will be performed.

As only limited assurance is being expressed, the work does not need to be as in depth as for an audit.

The **objective of a review of financial statements** is to perform primarily inquiry and analytical procedures, to enable the practitioner to conclude whether anything has come to their attention that causes them to believe that the financial statements are not prepared in all material respects in accordance with the applicable financial reporting framework. [ISRE 2400, 14]

Incorporation and the separation of ownership and control

Businesses can operate as sole traders, partnerships or limited companies. Limited company status offers protection to investors as they cannot be held personally responsible for the company's debts. The creation of a limited company is referred to as **incorporation**.

Incorporation has the following implications:

- The creation of a legal distinction between the owners of the business and the business itself.
- The opportunity for the owners/investors to detach themselves from the operation of the business.
- The need for managers to operate the business on a daily basis.

Incorporation provides financial protection for shareholders, but leads to a potentially significant conflict:

- Shareholders seek to maximise their wealth through increasing the value of their shareholding. This is driven by the profitability of the company.
- Directors/management seek to maximise their wealth through salary, bonuses and other employment benefits. This reduces the company's profitability.

This conflict led to the legal requirement for **financial statements** to be produced by directors to allow the shareholders to assess the performance of management.

Accountability, agency and stewardship

Key definitions:

Accountability means that people in a position of power can be held to account for their actions, i.e. they can be compelled to explain their decisions and can be criticised or punished if they have abused their position.

Accountability is central to the concept of good corporate governance – the process of ensuring that companies are well run – which we will look at in more detail in the chapter 'Corporate governance'.

Agency occurs when one party, the principal, employs another party, the agent, to perform a task on their behalf.

Stewardship is the responsibility to take good care of resources. A steward is a person entrusted with management of another person's property, for example, when one person is paid to look after another person's house while the owner goes abroad on holiday. The steward is responsible for the way they carry out their role.

This relationship, where one person has a duty of care towards someone else is known as a **'fiduciary relationship'**.

A **fiduciary relationship** is a relationship of 'good faith' such as that between the directors of a company and the shareholders of the company. There is a 'separation of ownership and control' in the sense that the shareholders own the company, while the directors make the decisions. The directors must make their decisions in the interests of the shareholders rather than in their own selfish personal interests.

Therefore:

- The directors are the stewards of the company.
- The shareholder is the principal, employing the directors (the agents) to run the company on their behalf.
- The directors are accountable to the shareholders for the way in which they run the company.

Examples of stakeholder groups

Stakeholder groups with an interest in the financial statements

- Shareholders can decide whether to alter their shareholdings.
- Employees may be able to judge whether they think their levels of pay are adequate compared to the directors. They may also be interested in the results of the company as this may impact their employment decisions.
- Those charged with governance can see whether they think management has struck the right balance between its own need for reward (remuneration, share options, etc.) and the needs of other stakeholders.
- Customers can make judgements about whether the company has sufficient financial strength (i.e. liquidity) to justify future trading.
- Suppliers and lenders can assess financial stability before giving credit.
- The government can decide whether the right amount of tax has been paid and whether the company appears to be compliant with the relevant laws and regulations.

Test your understanding 1

List and explain the elements of an assurance engagement.

(5 marks)

Test your understanding 2

Explain the term 'limited assurance' in the context of an examination of a company's cash flow forecast and explain how this differs from the assurance provided by an external audit.

(5 marks)

Test your understanding 3

Your firm has been approached to perform the external audit of Perth Co. Perth Co has grown over the last two years and has now reached the audit threshold. As this is the first year the company has required an audit, the directors are unsure about the purpose of the audit. They have been informed that an audit need not be as inconvenient or intrusive as they expect it to be as there are additional benefits that may arise from having an audit. The directors have indicated that they expect your firm to detect every fraud and error in the accounting records so that when they need to apply for finance to help them grow further, they can use the audited financial statements to support the loan application and this should make it easier to obtain the loan.

1 **What level of assurance will be provided by the independent auditor's report?**

A Absolute

B Reasonable

C Moderate

D Limited

2 **Which of the following is NOT one of the five elements of an assurance engagement?**

A Subject matter

B Suitable criteria

C Assurance file

D Written report

3 **Which of the following is NOT a benefit of an audit?**

A Increased credibility of the financial statements

B Deficiencies in controls may be identified during testing

C Fraud may be detected during the audit

D Sampling is used

4 **Which of the following statements is FALSE?**

A The auditor will express an opinion as to whether the financial statements give a true and fair view

B The auditor must obtain sufficient and appropriate evidence to be able to form an audit opinion

C If the financial statements are found to contain material misstatements a negative audit opinion will be given

D An audit may not detect all fraud and error in the financial statements

5 **Which of the following are examples of the expectation gap?**

(i) The independent auditor's report confirms the financial statements are accurate.

(ii) An unmodified opinion means the company is a going concern.

(iii) The auditor tests all transactions.

(iv) The auditor can be sued for negligence if they issue an inappropriate opinion.

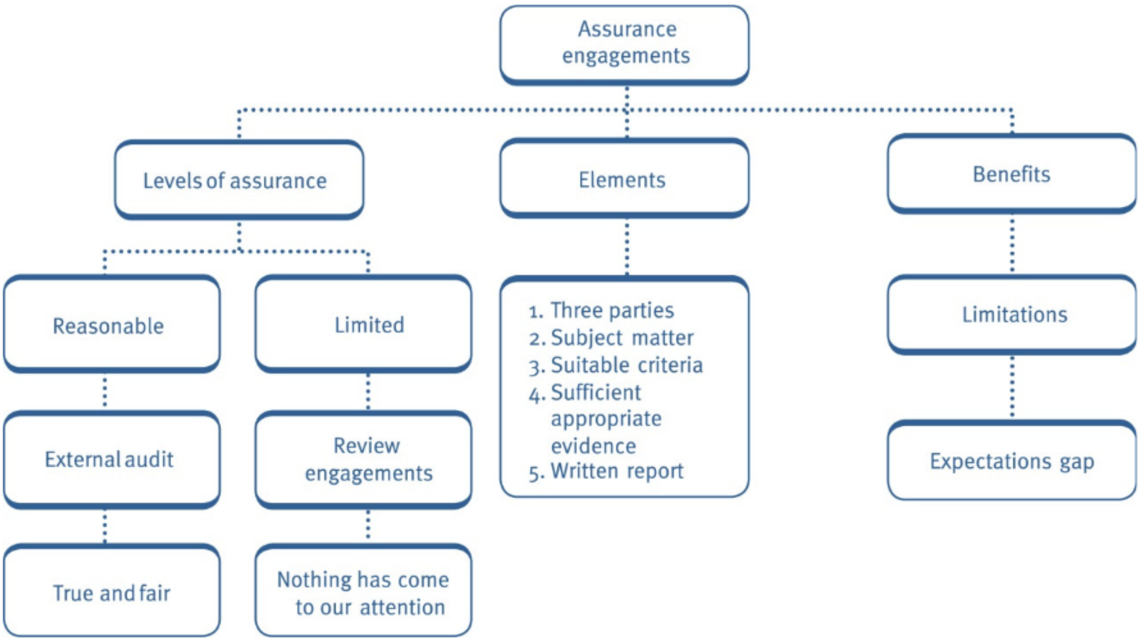
A (i), (ii) and (iii)

B (i), (ii) and (iv)

C (i) and (ii) only

D (ii) and (iii) only

4 Chapter summary



Test your understanding answers

Test your understanding 1

1 An assurance engagement will involve three separate parties:

(i) Intended user − the person who requires the assurance report.

(ii) Responsible party − the person or organisation responsible for preparing the subject matter to be reviewed.

(iii) Practitioner (i.e. an accountant) − the professional, who will review the subject matter and provide the assurance.

2 A suitable subject matter. This is the information that the responsible party has prepared and which requires verification.

3 Suitable criteria. The subject matter is compared to the criteria in order for it to be assessed and an opinion/conclusion provided.

4 Sufficient and appropriate evidence has to be obtained by the practitioner in order to give the required level of assurance.

5 An assurance report contains the opinion/conclusion that is given by the practitioner to the intended user.

Test your understanding 2

Limited assurance in the context of a cash flow forecast	**Assurance provided by an external audit**
Limited assurance is a moderate level of assurance.	An audit provides reasonable assurance, which is a high level.
The objective of a limited assurance engagement in the context of a cash flow forecast is to obtain sufficient appropriate evidence that the forecast is plausible in the circumstances i.e. prepared on the basis of reasonable assumptions.	The objective of an audit is to obtain sufficient appropriate evidence that the financial statements conform in all material respects with the relevant financial reporting framework.

A limited assurance report provides a negative conclusion. The practitioner will state that nothing has come to their attention which indicates that the assumptions used to prepare the cash flow forecast are not reasonable. The assurance is therefore given on the absence of any indication to the contrary.	An auditor's report provides a positive opinion as to whether or not the financial statements give a true and fair view. A positive opinion means the auditor is confident about the statement they are making, i.e. confident that the financial statements give a true and fair view or confident that they do not give a true and fair view.
With limited assurance, limited procedures are performed. In the context of a forecast, procedures will be limited as the transactions and events haven't occurred yet.	More evidence will need to be obtained to provide reasonable assurance, and a wider range of procedures performed, including tests of controls.
A forecast relates to the future, which is inherently uncertain, and therefore it would not be possible to obtain assurance that it is free from material misstatement.	Financial statements relate to the past, and so the auditor should be able to obtain sufficient and appropriate evidence.
Less reliance can therefore be placed on the forecast than the financial statements.	

Test your understanding 3

1	B	Reasonable assurance is given in an independent auditor's report.
2	C	Assurance file.
3	D	Sampling provides a limitation of the audit process, not a benefit.
4	C	A negative conclusion is used for limited assurance engagements.
5	A	The auditor cannot confirm the accuracy of the financial statements as they contain estimates and judgements of management. The company may not be a going concern and the financial statements may correctly reflect this resulting in an unmodified audit opinion. The auditor does not test all transactions.

Chapter

2

Rules and regulation

Chapter learning objectives

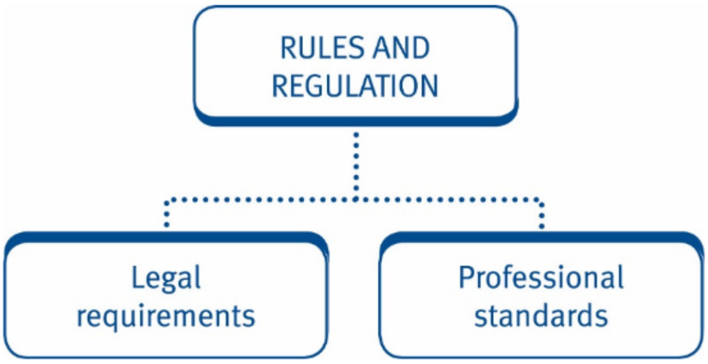
This chapter covers syllabus areas:

- A2 – External audits

Detailed syllabus objectives are provided in the introduction section of the text book.

PER

One of the PER performance objectives (PO4) is governance risk and control. You contribute to effective governance in your area. You evaluate, monitor and implement risk management procedures, complying with the spirit and the letter of policies, laws and regulations. Working through this chapter should help you understand how to demonstrate that objective.



1 The need for regulation

The role of the auditor has come under increased scrutiny over the last 30 years due to an increase in high profile audit failures. The most high-profile case, and the catalyst for regulatory change, was the collapse of Enron and its auditor Arthur Andersen.

In order to try and regain trust in the auditing profession, national and international standard setters and regulators have tried to introduce three initiatives:

- **Harmonisation** of auditing procedures, so that users of audit services are confident in the nature of audits being conducted around the world.
- Focus on **audit quality**, so that the expectations of users are met.
- Adherence to a strict **ethical code** of conduct, to try and improve the perception of auditors as independent, unbiased service providers.

In order to achieve this, practitioners have to follow regulatory guidance:

- **National corporate law (e.g. The Companies Act 2006 in the UK and The Sarbanes Oxley Act in the US).**
- **Auditing Standards** (the basis of this text is International Standards on Auditing).
- **Code of Ethics.** Covered in the chapter 'Ethics and acceptance'.

2 Legal requirements for audits and auditors

In this section, the law referred to in most cases is UK law and the Companies Act 2006. Different countries may have different requirements but generally the same principles will apply across the world. Some of the knowledge learned in Corporate and Business Law will be relevant here.

National law includes:

- Which companies are required to have an audit
- Who can and cannot carry out an audit
- Auditor appointment, resignation and removal
- The rights and duties of an auditor.

Who needs an audit and why?

In most countries, companies are required by law to have an audit.

Small or owner-managed companies are often exempt. This is because there is less value in an audit for these companies.

Note that these exemptions often do not apply to companies in certain regulated sectors, e.g. financial services companies or companies listed on a stock exchange.

Reasons for exempting small companies from audit

- The owners and managers of the company are often the same people.
- The advice and value which accountants can add to a small company is more likely to concern other services, such as accounting and tax.
- The impact of misstatements in the financial statements of small companies is unlikely to be material to the wider economy.
- The audit fee and disruption of an audit are seen as too great a cost for any benefits the audit might bring.

Who may act as auditor?

To be **eligible** to act as **auditor,** a person must be:

- A member of a Recognised Supervisory Body (RSB), e.g. ACCA, and allowed by the rules of that body to be an auditor **or**
- Someone directly authorised by the state.

Conducting audit work

Individuals who are authorised to conduct audit work may be: • Sole practitioners • Partners in a partnership • Members of a limited liability partnership • Directors of an audit company.	To be eligible to offer audit services, a firm must be: • Controlled by members of a suitably authorised supervisory body or • A firm directly authorised by the state.

Note: In some countries, only individuals can be authorised to act as auditor and need to be directly authorised by the state.

Who may not act as auditor?

Excluded by law: The law in most countries excludes those who manage or work for the company, and those who have business or personal connections with them from auditing that company.

Excluded by the Code of Ethics: Auditors must also comply with a Code of Ethics. The Code of Ethics requires the auditor to consider any factors that would prevent them acting as auditor, such as independence, competence or issues regarding confidentiality. This is considered in more detail in the chapter 'Ethics and acceptance'.

Who appoints the auditor?

Members (shareholders) – of the company appoint the auditor by voting them in.

Directors – can appoint the first auditor or to fill a 'casual vacancy'. This requires the members' approval at a members' meeting. In some countries the auditor may be appointed by the directors as a matter of course.

Secretary of State – if no auditor is appointed by the members or directors.

Auditors of public companies are appointed from one AGM to the next one.

Auditors of private companies are appointed until they are removed.

Removing the auditor

Arrangements for removing the auditor have to be structured in such a way that:

- the auditor has sufficiently secure tenure of office, to maintain independence of management.
- the auditor can be removed if there are doubts about their continuing ability to carry out their duties effectively.

Removal of the auditor can usually be achieved by a simple majority at a general meeting of the company. There are some safeguards, such as a specified notice period, to prevent the resolution to remove the auditor being suggested at short notice in order to influence the outcome of the vote.

The auditor can circulate representations stating why they should not be removed if applicable.

A statement of circumstances must be sent to the company and the regulatory authority to set out issues surrounding the cessation of office.

Resigning as auditor

In practice, if the auditor and management find it difficult to work together, the auditor will usually resign.

On resignation, the auditor issues written notice of the resignation and a statement of circumstances to the members and regulatory authority.

Notifying ACCA

If an auditor resigns or is removed from office before the end of their term of office, they must notify the ACCA.

The auditor's responsibilities on removal/resignation

The following is taken from UK law, but provides an example of the typical responsibilities of the auditor.

- Deposit at the company's registered office:
  - A statement of the circumstances connected with the removal/resignation, or
  - A statement that there are no such circumstances.
- Deal promptly with requests for clearance from new auditors.

The auditor's rights

During appointment as auditor

- Access to the company's books and records at any reasonable time.
- To receive information and explanations necessary for the audit.
- To receive notice of and attend any general meeting of members of the company.
- To be heard at such meetings on matters of concern to the auditor.
- To receive copies of any written resolutions of the company.

On resignation

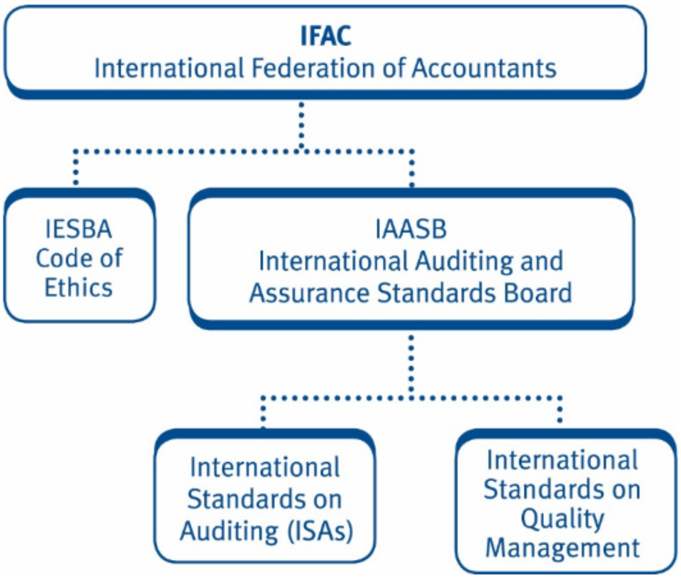
- To request a General Meeting of the company to explain the circumstances of the resignation.
- To require the company to circulate the notice of circumstances relating to the resignation.

The auditor's duties

The external auditor's primary duty is to audit the financial statements and provide an opinion on whether the financial statements give a true and fair view (or are fairly presented in all material respects).

They may have additional reporting responsibilities required by local national law, such as confirming that the financial statements are properly prepared in accordance with those laws.

3 International regulation



The International Federation of Accountants (IFAC)

The International Federation of Accountants (IFAC) is the global organisation for the accountancy profession.

IFAC promotes international regulation of the accountancy profession. By ensuring minimum requirements for accountancy qualifications, post qualification experience and guidance on accounting and assurance for accountants around the world, there will be greater public confidence in the profession as a whole.

International Standards on Auditing (ISAs)

One of the subsidiary boards of IFAC is the International Audit and Assurance Standards Board (IAASB). It is the IAASB's responsibility to develop and promote International Standards on Auditing (ISAs).

There are currently 37 ISAs and two International Standards on Quality Management, although not all are examinable for this syllabus. A list of examinable documents is available on the ACCA website. You do not need to learn the names or numbers of the ISAs but you do need to know and be able to apply the key principles and requirements of the standards.

Main features of ISAs

- ISAs are professional guidance that the auditor must follow to ensure each audit is performed consistently and to a required standard of quality.
- ISAs are not legal requirements. If a country has a law in place which is inconsistent with the requirements of the ISAs, local law should be followed.

- ISAs are written in the context of an audit of the financial statements but can be applied to the audit of other historical financial information.
- ISAs must be applied in all but exceptional cases. Where the auditor deems it necessary to depart from an ISA to achieve the overall aim of the audit, this departure must be justified.
- ISAs contain basic principles and requirements followed by application and other explanatory material to aid the auditor on how to follow the requirements.

Development of ISAs

For an ISA to be issued, a lengthy process of discussion and debate occurs to ensure the members affected by the guidance have had an input.

An exposure draft (ED) is issued for public comment and these comments may result in revisions to the ED.

Approval of two thirds of IAASB members is required for the ISA to come into force.

The relationship between international and national standards and regulation

IFAC is simply a grouping of accountancy bodies, therefore it has no legal standing in individual countries. Countries therefore need to have their own arrangements in place for:

- Regulating the audit profession
- Implementing auditing standards.

National standard setters

- may develop their own auditing standards and ethical standards
- may adopt and implement ISAs, possibly after modifying them to suit national needs.

In the event of a conflict between the two sets of guidance, local regulations will apply.

UK as an example

In the UK, the Financial Reporting Council (FRC) is currently the national regulator responsible for overseeing the accountancy profession.

The Audit and Actuarial Regulation Division within the FRC is responsible for the development of auditing standards and guidance in the UK, monitoring of auditors of public interest entities, and oversight and regulation of Recognised Supervisory Bodies (such as ACCA).

The Audit and Assurance team within the Audit Division take the ISAs as issued by the IAASB and modify them for UK use.

The Audit and Assurance team has also developed its own ethical standard which must be followed. The safeguards within the ethical standard are either the same as those required by the International Ethics Standards Board for Accountants (IESBA) International Code of Ethics for Professional Accountants, or more comprehensive. For example, partner rotation rules in the UK are more stringent than those required by the IESBA.

The Audit Quality Review (AQR) team monitors the quality of work performed by audit firms that perform audits of public interest entities in the UK. The AQR performs inspections of audit files to ensure firms are following the requirements of the ethical standard, auditing standards and quality management standards. Inspection reports are available to view on the FRC website.

The accountancy profession in the UK is therefore primarily self-regulated with little government involvement in the regulation of accountancy firms.

At the time of writing, the FRC is in transition to a new regulatory authority, The Audit, Reporting and Governance Authority (ARGA). This action is being taken in response to a number of high-profile accounting irregularities over recent years, such as Carillion and Patisserie Valerie. The UK government ordered a review of the regulatory system which recommended the introduction of a new regulator. The FRC was criticised for being too close to those that it is supposed to regulate creating a conflict of interest resulting in an ineffective regulatory system. It is expected that ARGA will be more proactive in taking action against firms who fail to uphold the reputation of the profession.

4 The role of professional bodies

Professional bodies (such as the ACCA and ICAEW) promote quality within the profession through provision of:

- Rigorous qualifications to acquire the knowledge and skills needed to provide a competent service.
- Support to members to demonstrate high professional and ethical values.
- Technical expertise to governments on accounting and business matters. This input may help shape the introduction of new laws and regulations affecting the profession.

To obtain membership to a professional body, a person must:

- Successfully complete the exams provided by that body
- Be able to demonstrate appropriate practical experience (usually a minimum of three years)
- Complete an ethical assessment.

To maintain membership, a member must demonstrate continuing professional development (CPD) to ensure knowledge and skills are kept up to date. In addition, members must comply with a code of ethics and conduct to ensure they act in a professional manner at all times.

If a member is found not to have complied with the rules of the professional body, disciplinary action will be taken which may involve fines, reprimands, suspension from membership for a limited time, or withdrawal of membership. Most disciplinary matters will be dealt with internally by the relevant professional body. However, if the behaviour of the person or the firm is considered very serious, the matter can be referred to the national regulator and action can be taken at a higher level. This will generally be the case for significant public interest issues.

By having such rigorous membership requirements and disciplinary proceedings, the public can be assured that professional accountants are performing work of a high standard which increases trust in the profession as a whole.

Test your understanding 1

(a) Explain FOUR rights that enable auditors to carry out their duties. (4 marks)

(b) State the circumstances in which a person is not eligible to act as an auditor. (3 marks)

(c) Describe the steps required to remove an auditor from an engagement. (3 marks)

(Total: 10 marks)

Test your understanding 2

You have been asked to conduct a training workshop for your firm's new trainees which will cover the rules and regulations surrounding the auditing profession. You have prepared a short test for the trainees to take at the end of the workshop to assess whether they have understood the content covered.

1 **Which of the following statements is FALSE?**

A Auditing standards are laws which must be followed during all audits

B Auditing standards should be followed during all audits unless there are exceptional circumstances which would mean the audit objective would not be met

C Auditing standards are professional regulations

D Auditing standards may be different in different countries, even those using ISAs

2 **Which of the following are reasons for the audit profession issuing auditing standards?**

(i) To ensure consistency of audits across different firms.

(ii) To provide bureaucracy for auditors.

(iii) To ensure quality in the standard of audits performed.

A All of them

B (i) and (ii) only

C (i) and (iii) only

D (ii) and (iii) only

3 **Which of the following people may act as auditor for a company?**

A The company's previous finance director who left the company five years ago to join the audit firm

B A director of the company being audited who holds a valid audit certificate

C An employee of the company being audited who holds a valid audit certificate

D The wife of the finance director who works for a reputable audit firm

4 **In most jurisdictions, the auditors of a company will be appointed by which party?**

A Directors

B Audit committee

C Government

D Shareholders

5 **Which of the following statements is TRUE?**

A The shareholders of most companies will also be the directors

B The directors are the stewards of the company responsible for looking after the company on behalf of the owners

C Directors will always have a vested interest in the company doing well because they own shares in the company they work for

D Auditors are allowed to be business partners of the company directors

Test your understanding 3

You have recently started a training contract at an accountancy firm, Nauru & Co, to become a chartered certified accountant. You will be working in the audit and assurance department where your mother is an audit engagement partner.

Nauru & Co has several audit clients, although not as many as in the past due to the audit threshold being increased significantly over the last 15 years. Current regulations require all public interest entities and companies with revenue of $10 million and at least 50 employees to be audited.

Nauru & Co has recently won the tender for the audit of Vanuatu Co. Your mother will be the engagement partner for this client. You have confirmed that you are independent of management and those charged with governance of Vanuatu Co.

Malta Co has approached your firm for advice on whether they require an audit. Malta Co has 75 employees and revenue of $8 million. Malta Co is a financial institution providing banking and insurance services. Malta Co has three shareholders who are all directors of the company.

1 **Which of the following must you complete to become a chartered certified accountant?**

(i) Three years of exams.

(ii) Practical experience of a minimum of three years.

(iii) An ethics assessment.

A All of them

B (i) and (ii) only

C (i) and (iii) only

D (ii) and (iii) only

2 **Which of the following statements is TRUE in respect of the audit of Vanuatu Co?**

A You will be able to be a member of the audit team as you are independent of the client

B You will be able to be a member of the audit team as you are a new employee of the firm and have not had time to build up any relationships which will impact your independence

C You will not be able to be a member of the audit team as your mother is the engagement partner

D You will not be able to be a member of the audit team as you have no audit experience and therefore are not competent to perform audit work

3 **Which of the following statements is TRUE in respect of Malta Co?**

A Malta Co requires an audit as the number of employees is over 50

B Malta Co requires an audit because it is a financial services company

C Malta Co does not require an audit as revenue is below $10 million

D Malta Co does not require an audit as all shareholders are directors

4 **Which TWO of the following will ensure the quality of work performed by accountancy firms such as Nauru & Co is at a high standard?**

A The firm must establish its own quality policies and procedures

B The firm will be subject to quality reviews by the courts

C The firm will be subject to quality reviews by the IAASB

D The threat of legal action by ACCA will encourage a high level of quality

E The firm will be subject to quality reviews by ACCA

5 **Which of the following is NOT a right of the auditor during appointment?**

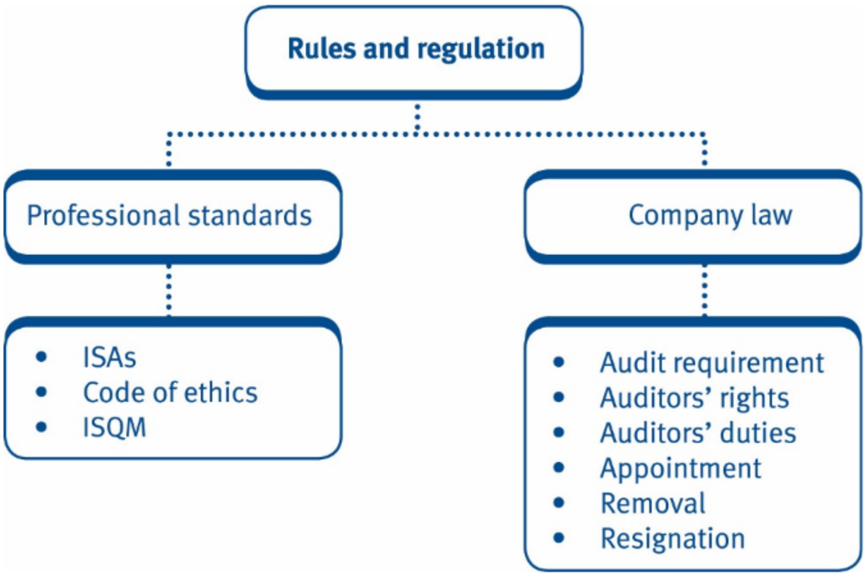
A To speak at general meetings of the shareholders about audit matters

B To have access to the company's books and records

C To receive copies of the written resolutions of the company

D To receive notice of, and attend, board meetings of the directors

5 Chapter summary



Test your understanding answers

Test your understanding 1

(a) **Rights of the auditor**

- Right of access to the company's books and records at any reasonable time to collect the evidence necessary to support the audit opinion.
- Right to require from the company's officers the information and explanations the auditor considers necessary to perform their duties as auditor.
- Right to receive notices of, and attend meetings of, the company in the same way as any member of the company.
- Right to speak at general meetings on any matter affecting the auditor or previous auditor.
- Where the company uses written resolutions, a right to receive a copy of those resolutions.

(b) **Auditor eligibility**

A person is not eligible to act as an auditor in the following circumstances:

- They are not a member of a recognised supervisory body (RSB) or not allowed to practise under the rules of an RSB.
- They are an officer or employee of the company.
- They are a business partner or employee of such a person.

(c) **Steps required to remove an auditor from an engagement**

- A decision must be made by the shareholders at a general meeting usually with a majority vote being required.
- Advance notice must be given to the company and the auditors prior to any general meeting.
- Auditors have the right to attend and speak at the general meeting or have representations read out on their behalf.

Test your understanding 2

1	A	Auditing standards are professional guidance, not law.
2	C	By issuing standards, audits should be performed more consistently which should improve quality.
3	A	An auditor cannot be an employee or director of the company or someone with a close personal relationship with someone that could influence the audit. An ex-employee or director can be involved with the audit once a cooling-off period has passed.
4	D	Shareholders.
5	B	Whilst directors may be shareholders of the company they work for, large public companies will have a significant number of shareholders who are not involved in the operations of the company. Auditors are not allowed to be business partners of the directors of a company they audit.

Test your understanding 3

1	D	To become a chartered certified accountant an individual must pass the required exams, demonstrate practical experience of a minimum of three years and complete an ethical assessment. The exams do not need to take three years. In some cases, individuals may take less time, in others they may take more time.
2	C	You will not be able to be on the audit team as your mother is the engagement partner and this creates an ethical threat. Your mother may be more lenient when reviewing your work which will impact on the quality of the engagement. All new auditors have to start somewhere. Competence is addressed by the firm providing adequate training and supervision of audit team members. All work will be reviewed to ensure it has been performed competently.
3	B	Malta Co requires an audit because it is a financial services company and therefore a public interest entity. Malta Co would not require an audit if it was not a public interest entity as the audit threshold has not been met. The audit threshold requires a company to meet both conditions, revenue of at least $10 million AND more than 50 employees.

4	A, E	All professional accountancy firms must comply with professional regulations including quality standards. These standards require firms to implement policies and procedures to ensure reports issued are appropriate. The firm must monitor its own policies and procedures to ensure they are relevant, adequate and working effectively. ACCA will periodically perform quality reviews of firms to ensure compliance with professional standards. Quality reviews are not undertaken by the IAASB as this is the body responsible for developing new ethical and auditing standards to be used by firms. The auditor's work is not subject to legal investigation or review unless a claim is brought against a firm for breach of contract or negligence.
5	D	The auditor only has a right to attend general meetings of the shareholders, not the meetings of the directors.

Chapter

3

Corporate governance

Chapter learning objectives

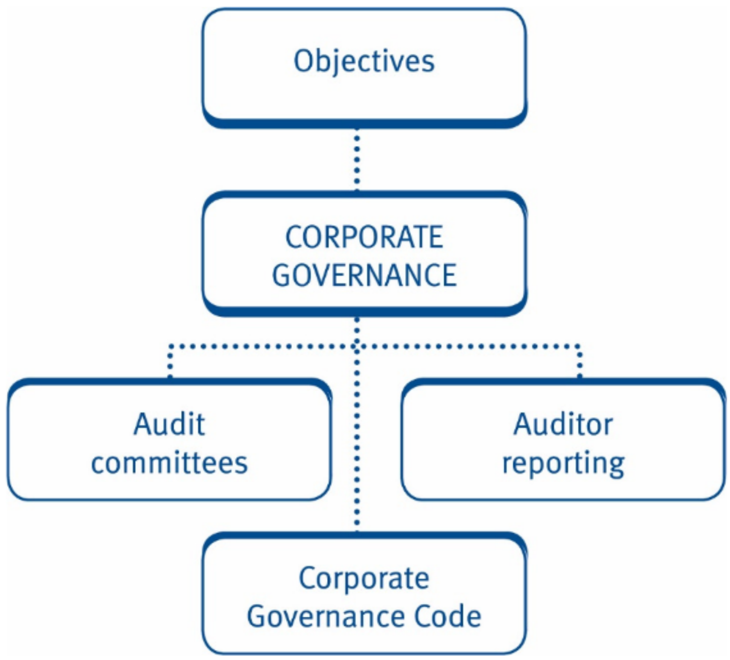
This chapter covers syllabus areas:

- A3 – Corporate governance

Detailed syllabus objectives are provided in the introduction section of the text book.

PER

One of the PER performance objectives (PO4) is governance risk and control. You contribute to effective governance in your area. You evaluate, monitor and implement risk management procedures, complying with the spirit and the letter of policies, laws and regulations. Working through this chapter should help you understand how to demonstrate that objective.



This chapter further develops the principles of corporate governance covered in Business Technology (previously Accountant in Business) at the Applied Knowledge level.

1 Objectives and importance of corporate governance

Corporate governance is the means by which a company is operated and controlled.

The aim of corporate governance is to ensure that companies are run well in the interests of their shareholders, employees, and other key stakeholders such as the wider community.

The aim is to try and prevent company directors from abusing their power which may adversely affect these stakeholder groups. For example, the directors may pay themselves large salaries and bonuses whilst claiming they have no money to pay a dividend to shareholders. Similarly, they may be making large numbers of staff redundant but awarding themselves a pay rise.

In response to major scandals (e.g. Enron), regulators sought to change the rules surrounding the governance of companies, particularly publicly owned ones.

In the US, the Sarbanes Oxley Act (2002) introduced a set of rigorous corporate governance laws. The UK Corporate Governance Code introduced a set of best practice corporate governance initiatives into the UK.

Advantages of a company following good corporate governance principles:

- Greater transparency
- Greater accountability
- Efficiency of operations
- Better able to respond to risks
- Less likely to be mismanaged.

High profile corporate failures

Carillion

In 2018, construction company Carillion was placed into liquidation after building up debts of £1.5 billion. The company was a major contractor for the UK government with contracts to build hospitals and schools, as well as facilities management and ongoing maintenance. It was the second largest construction company in the UK and employed more than 43,000 people. The company took on too many projects and failed to realistically price the contracts resulting in huge cost overruns and losses being made. In December 2017 the major banks refused to lend more money to Carillion and in 2018 the company went into liquidation.

The collapse of the company caused significant problems, not just for the shareholders, but for the significant number of employees who lost their jobs, the government contracts that were in progress that would not be completed, and for the suppliers who would not be paid.

One of the issues highlighted by Carillion was that of executive pay. Executive directors were earning significant amounts of money despite running the company into the ground. In 2016, the former chief executive director earned more than £2 million. The Institute of Directors has said that the collapse of Carillion was due to a lack of effective governance. Directors' remuneration allowed them to benefit despite the collapse of the company as there were no claw back conditions. The company could only request claw back from directors if there was gross misconduct or misstatement of financial results. The directors also received payoffs despite being responsible for the collapse.

The collapse of Carillion has also returned focus to the big accounting firms and their part in allowing companies to fail by not having raised the alarm much earlier.

Enron

In the year 2000 Enron, a US based energy company, employed 22,000 people and reported revenues of $101 billion. In late 2001 they filed for bankruptcy protection. After a lengthy investigation it was revealed that Enron's financial statements were sustained substantially by systematic, and creatively planned, accounting fraud.

In the wake of the fraud case the shares of Enron fell from over $90 each to just a few cents each and a number of directors were prosecuted and jailed. The auditors, Arthur Andersen, were accused of obstruction of justice and forced to stop auditing public companies. This ruling against Arthur Andersen was overturned at a later date but the damage was done and the firm ceased trading soon after.

This was just one of a number of high profile frauds to occur at that time.

The Enron scandal is an example of the abuse of the trust placed in the management of publicly traded companies by investors. This abuse of trust usually takes one of two forms:

- Direct extraction from the company of excessive benefits by management, e.g. large salaries, pension entitlements, share options, use of company assets (jets, apartments etc.)
- Manipulation of the share price by misrepresenting the company's profitability, usually so that shares in the company can be sold or options 'cashed in'.

In response, regulators sought to change the rules surrounding the governance of companies, particularly publicly owned ones. In the US the Sarbanes Oxley Act (2002) introduced a set of rigorous corporate governance laws and at the same time the Combined Code (now called the UK Corporate Governance Code) introduced a set of best practice corporate governance initiatives into the UK.

2 The Corporate Governance Code

The Organisation for Economic Co-operation and Development (OECD) has produced a set of six principles of corporate governance to guide policy makers when setting regulations for their own country.

The six OECD principles are:

- Ensuring the basis of an effective corporate governance framework
- The rights and equitable treatment of shareholders and key ownership functions
- Institutional investors, stock markets, and other intermediaries
- The role of stakeholders in corporate governance
- Disclosure and transparency
- The responsibilities of the board.

The UK Corporate Governance Code reflects the OECD principles.

The UK Corporate Governance Code is particularly important for publicly traded companies because large amounts of money are invested in them, either by 'small' shareholders, or from pension schemes and other financial institutions. The wealth of these companies significantly affects the health of the economies where their shares are traded.

The code is split into five parts:

- Board leadership and company purpose
- Division of responsibilities
- Composition, succession and evaluation
- Audit, risk and internal control
- Remuneration.

The Code does not set out a rigid set of rules; instead it offers flexibility through the application of principles and 'comply or explain' provisions and supporting guidance.

The main requirements provisions of the Code are given below.

Board leadership and company purpose

Principles

- A successful company is led by an effective board whose role is to promote long-term sustainable success thereby generating value for shareholders.
- The board should establish the company's purpose, values and strategy. The directors should lead by example and promote the desired culture.
- The board should ensure that the necessary resources are in place for the company to meet its objectives. The board should establish a framework of effective controls to enable risk to be assessed and managed.
- The board should ensure effective engagement with, and encourage participation from shareholders and stakeholders.
- The board should ensure that workforce policies and practices are consistent with the company's values. The workforce should be able to raise matters of concern.

Main provisions

- The board should describe in the annual report how opportunities and risks to the future success of the business have been considered and addressed.
- The board should assess and monitor culture. Where behaviour throughout the business is not consistent with the purpose, values or strategy, the board should ensure management has taken corrective action.
- In addition to formal general meetings, the chair should seek regular engagement with major shareholders. The board as a whole should understand the views of the shareholders.

- When 20% or more of votes have been cast against the board recommendation for a resolution, the company should explain what actions it intends to take to understand the reasons behind the result.
- The board should understand the views of the company's other key stakeholders and describe how their interests have been considered in board discussions. For engagement with the workforce, the company should use a director appointed from the workforce, a workforce advisory panel or a designated non-executive director (NED).
- The workforce should be able to raise concerns in confidence and anonymously ('whistleblowing').
- The board should take action to manage conflicts of interest.
- Directors' concerns about the operation of the board or management of the company that cannot be resolved should be minuted. On resignation, a NED should provide a written statement to the chair for circulation to the board if they have any concerns.

Board roles

The chair's role

- Leads the board of directors.
- Enables flow of information and discussion at board meetings.
- Ensures satisfactory channels of communication with the external auditors.
- Ensures effective operation of board sub-committees.
- The chair should be independent to enhance effectiveness.

The chief executive's role

- Ensures the effective operation of the company.
- Head of the executive directors.

Executive directors

The executive directors have responsibility for running the company on a day to day basis.

Non-executive directors (NEDs)

The NEDs monitor the executive directors and contribute to the overall strategy and direction of the organisation. They are usually employed on a part-time basis and do not take part in the routine executive management of the company.

NEDs will:

- participate at board meetings.
- bring experience, insight and contacts to assist the board.
- sit on sub-committees as independent, knowledgeable parties.

Advantages of participation by NEDs

- Oversight of the whole board.
- As they are independent they act as a 'corporate conscience'.
- They bring external expertise to the company.

Disadvantages

- It may be difficult to find the right NEDs who have the relevant skills and experience required by the company.
- They, and the sub-committees, may not be sufficiently well-informed or have time to fulfil the role competently.
- They are subject to the accusation that they are staffed by an 'old boys' network and may fail to report significant problems and approve unjustified pay rises.
- The cost. NEDs are normally remunerated and their fees can be quite expensive.

Division of responsibilities

Principles

- The chair leads the board and is responsible for its overall effectiveness.
- The chair should ensure effective contribution of all board members.
- The chair should ensure that directors receive clear, accurate and timely information.
- The board should be balanced so that no individual or small group of individuals can dominate board decisions.
- NEDs should have sufficient time to meet their board responsibilities and should hold management to account.
- The board should ensure it has the policies, processes, information, time and resources it needs to function effectively and efficiently.

Main provisions

- The chair should be independent on appointment.
- The chair and chief executive roles should not be taken by the same individual. The chief executive should not become the chair of the same company.

- At least half the board, excluding the chair should be independent NEDs.
- The board should identify the independent NEDs in the annual report. Independence would be deemed to be affected if a director:
  - is, or has been, an employee of the company or group within the last five years
  - has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company
  - has received or receives remuneration from the company in addition to a director's fee, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme
  - has close family ties with any of the company's advisers, directors or senior employees
  - holds cross-directorships or has significant links with other directors through involvement in other companies or bodies
  - represents a significant shareholder
  - has served on the board for more than nine years from the date of their first appointment.
- One of the independent NEDs should be appointed as a senior independent director to provide a sounding board for the chair.
- The NEDs and the senior independent director should meet without the chair present at least annually to appraise the chair's performance.
- NEDs appoint and remove executive directors and scrutinise performance against agreed performance objectives.
- The responsibilities of the chair, chief executive, senior independent director, board and committees should be set out in writing and publicly available.
- The annual report should set out the number of meetings of the board and its committees and the attendance of each director.
- New appointments to the board should take into account other demands on the director's time. Full time executive directors should not take on more than one NED role in a FTSE 100 company or other significant appointment. Appointments should not be made without prior approval of the board.

Composition, succession and evaluation

Principles

- Appointments to the board should be subject to a formal, rigorous and transparent procedure.
- An effective succession plan should be maintained for board and senior management.
- Appointments and succession should be based on merit and objective criteria and should promote diversity.
- The board and its committees should have a combination of skills, experience and knowledge.
- Annual evaluation of the board should consider its composition, diversity and how effectively members work together to achieve objectives.

Main provisions

- A nomination committee should be established to appoint board members.
- A majority of the committee members should be independent NEDs.
- The chair should not be a member of the committee when the committee is dealing with the appointment of their successor.
- All directors should be subject to annual re-election.
- The chair should not remain in post for more than nine years from the date of their first appointment. This period can be extended for a limited time to facilitate effective succession planning.
- Open advertising and/or an external search consultancy should be used for the appointment of the chair and NEDs.
- There should be a formal and rigorous annual evaluation of the performance of the board, its committees, the chair and the individual directors.
- The chair should consider having a regular external board evaluation at least every three years for FTSE 350 companies, and the external evaluator should be identified in the annual report.
- The annual report should describe the work of the nomination committee including the process used in making appointments, how the board evaluation has been conducted, the policy on diversity and inclusion and the gender balance of those in senior management.

Nomination committee

The role of the nomination committee is to decide on appointments of board directors and senior management. This is to ensure the best person for the job is recruited. The majority of this committee should be independent NEDs.

Advantages

- Reduces the risk of 'jobs for the boys'. Executive directors might appoint other directors with whom they are friends or used to work with but do not have the skills required.
- Reduces the risk of improperly affecting board decisions. Executives might appoint people to the board they know will vote in favour of the same decisions as them and can therefore influence board decisions which may not be in the best interests of the company.

Audit, risk and internal control including audit committees

Principles

- The board should establish formal and transparent policies and procedures to ensure the independence and effectiveness of internal and external audit functions and satisfy itself on the integrity of financial and narrative statements.
- The board should present a fair, balanced and understandable assessment of the company's position and prospects.
- The board should establish procedures to manage risk, oversee the internal control framework, and determine the nature and extent of the principal risks the company is willing to take in order to achieve its long-term strategic objectives.

Main provisions

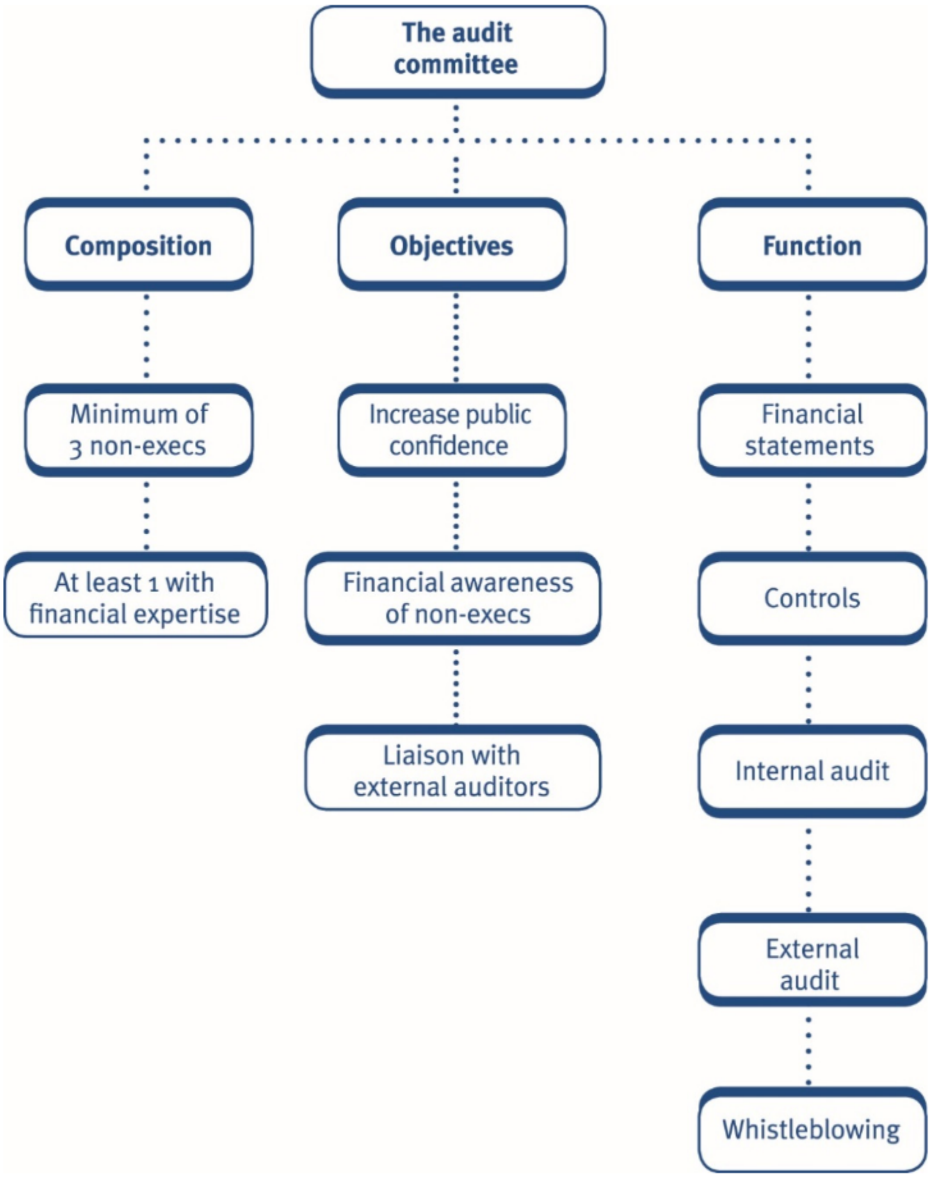
- The board should establish an audit committee of independent NEDs, with a minimum membership of three, or in the case of smaller companies, two.
- The chair of the board should not be a member of the audit committee.
- At least one member must have recent and relevant financial experience.
- The committee as a whole must have competence relevant to the sector in which the company operates.
- The main roles and responsibilities of the audit committee include:
  - Monitoring the integrity of the financial statements.
  - Providing advice on whether the annual report and accounts are fair, balanced and understandable.

- Reviewing the company's internal financial controls and risk management systems.
- Monitoring and reviewing the effectiveness of the internal audit function.
- If there is no internal audit function in place, they should consider annually whether there is a need for one and make a recommendation to the board.
- Making recommendations in relation to the appointment and removal of the external auditor and their remuneration.
- Reviewing and monitoring the external auditor's independence and objectivity and the effectiveness of the audit process.
- Developing and implementing policy on the engagement of the external auditor to supply non-audit services.

- The annual report should describe the work of the audit committee including:
  - Significant issues considered relating to the financial statements.
  - How it has assessed the independence and effectiveness of the external audit process.
  - Where there is no internal audit function, an explanation for the absence and how internal assurance is achieved.
  - An explanation of how auditor independence and objectivity are safeguarded, if the external auditor provides non-audit services.
- The directors should explain in the annual report their responsibility for preparing the annual report and accounts.
- The board should carry out a robust assessment of the company's emerging and principal risks.
- The board should confirm in the annual report that it has completed this assessment, including a description of its principal risks, what procedures are in place to identify emerging risks, and an explanation of how these are being managed or mitigated.
- The board should monitor the company's risk management and internal control systems and, at least annually, carry out a review of their effectiveness and report on that review in the annual report. The monitoring and review should cover all material controls, including financial, operational and compliance controls.
- The board should state whether it considers it appropriate to adopt the going concern basis of accounting in preparing the financial statements, and identify any material uncertainties to the company's ability to continue to do so over a period of at least 12 months from the date of approval of the financial statements.

- The board should explain in the annual report how it has assessed the prospects of the company, over what period it has done so and why it considers that period to be appropriate.
- The board should state whether it has a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment.

Audit committees



The audit committee will take responsibility for financial reporting and internal control matters. The audit committee is able to view a company's affairs in a detached and independent way and liaise effectively between the main board of directors and the internal and external auditors.

The objectives of the audit committee

- Increasing public confidence in the credibility and objectivity of published financial information (including unaudited interim statements).
- Assisting directors (particularly executive directors) in meeting their responsibilities in respect of financial reporting.
- Strengthening the independent position of a company's external auditor by providing an additional channel of communication.

Benefits of an audit committee

- Improved credibility of the financial statements through an impartial review of the financial statements and discussion of significant issues with the external auditors.
- Increased public confidence in the audit opinion as the audit committee will monitor the independence of the external auditors.
- Stronger control environment as the audit committee help to create a culture of compliance and control.
- The skills, knowledge and experience (and independence) of the audit committee members can be an invaluable resource for a business.
- It may be easier and cheaper to arrange finance, as the presence of an audit committee can give a perception of good corporate governance.
- It will be less of a burden to meet listing requirements if an audit committee (which is usually a listing requirement) is already established.
- The internal audit function will report to the audit committee increasing their independence and adding weight to their recommendations.

Disadvantages

- Difficulties recruiting the right non-executive directors who have relevant skills, experience and sufficient time to become effective members of the committee.
- Expensive as members of the committee will be paid for their time.

FRC Guidance on audit committees

This guidance is designed to assist company boards when implementing the Corporate Governance Code.

- Companies with a premium listing are required to comply with the Code or explain why they have not done so.
- Audit committee arrangements should be proportionate to the task and will vary according to size and complexity of the company.
- There should be a frank, open working relationship and a high level of mutual respect between audit committee chair and board chair, the chief executive and the finance director.
- Management must ensure the audit committee is kept properly informed. All directors must cooperate with the audit committee.
- The core functions of audit committees are oversight, assessment and review. It is not the duty of the audit committee to carry out functions that belong to others. For example, they should make sure there is a proper system in place for monitoring of internal controls but should not do the monitoring themselves.
- The board should review the audit committee's effectiveness annually.

The audit committee should:

- Receive induction and training for new members and continuing training as required.
- Hold as many meetings as the roles and responsibilities require and it is recommended that no fewer than three meetings are held.
- Meet the external and internal auditors without management at least annually to discuss any issues arising from the audit.
- Report to the board on how it has discharged its responsibilities.
- Ensure the interests of the shareholders are properly protected in relation to financial reporting and internal control.
- Review and report to the board on the significant financial reporting issues and judgements in connection with the preparation of the financial statements.
- Consider the appropriateness of significant accounting policies, significant estimates and judgements.
- Receive reports from management on the effectiveness of systems and the conclusions of any testing carried out by internal and external auditors.
- Review the systems established by management to identify, assess, manage and monitor financial risks.

- Monitor and review the effectiveness of the company's internal audit function. Where there is no internal audit function the audit committee should consider annually the need for one and make a recommendation to the board.
- Review whistleblowing arrangements for staff of the company to raise concerns in confidence.

Annual report

A separate section of the annual report should describe the work of the committee. Specifically:

- A summary of the role of the audit committee.
- The names and qualifications of all members of the audit committee.
- The number of audit committee meetings.
- The significant issues that the committee considered in relation to the financial statements and how these issues were addressed.
- An explanation of how it has assessed the effectiveness of the external audit process and the approach taken to the appointment or reappointment of the external auditor.
- If the external auditor provides non-audit services, how auditor objectivity and independence is safeguarded.
- Where there is a disagreement between the audit committee and the board which cannot be resolved, the audit committee should have the right to report the issue to shareholders as part of its report within the annual report.
- The audit committee chair should be present at the AGM to answer questions.

External audit matters

The audit committee is responsible for making a recommendation on the appointment, reappointment and removal of the external auditors.

FTSE 350 companies should put the audit out to tender at least once every ten years to enable the audit committee to compare the quality and effectiveness of the services provided by the incumbent auditor with those of other firms.

The audit committee should:

- Annually assess and report to the board on the qualification, expertise and resources, and independence of the external auditors and the effectiveness of the audit process.
- Investigate reasons for the resignation of the external auditor and consider whether any action is required.
- Assess the independence and objectivity of the external auditor annually.

- Set and apply a formal policy for non-audit services that are pre-approved, require approval or are not allowed.
- Agree a policy for employment of former employees of the external auditor taking into account the Ethical Standards, paying particular attention to people who were part of the audit team. The audit committee should consider whether there has been any impairment of the auditor's independence and objectivity in respect of the audit.
- Monitor the external audit firm's compliance with ethical standards relating to partner rotation and fee levels.

Internal audit

Internal audit has an important role to play in assisting the board, and audit committee, fulfil their corporate governance responsibilities.

Internal audit will work closely with the audit committee. The audit committee will:

- Ensure that the internal auditor has direct access to the board chair and to the audit committee and is accountable to the audit committee.
- Review and assess the annual internal audit work plan.
- Receive periodic reports on the results of internal audit work.
- Review and monitor management’s responsiveness to the internal auditor’s findings and recommendations.
- Meet with the head of internal audit at least once a year without the presence of management.
- Monitor and assess the effectiveness of internal audit in the overall context of the company’s risk management system.

The roles and functions of internal audit are covered in the chapter ‘Internal audit’.

Risk management in practice

The main aim of risk management is to protect the business from unforeseen circumstances that could negatively impact the profitability of the company and stop it achieving its strategic goals.

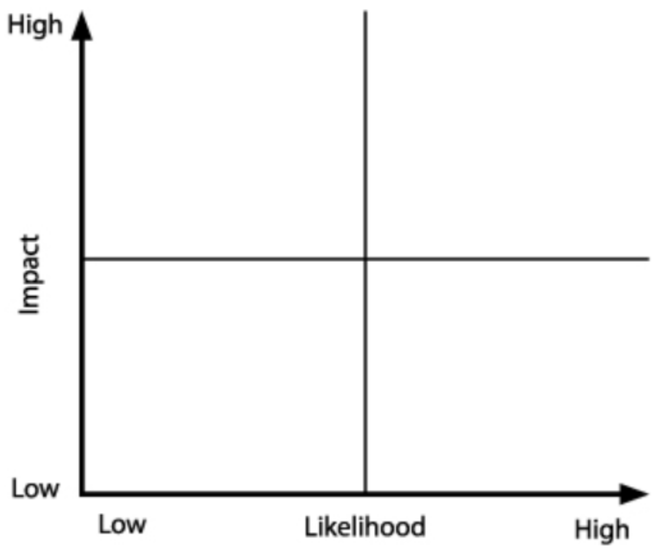
The board must monitor the company’s risk assessment and internal control systems annually. A risk committee may be established to perform this role. The risk committee will be responsible for advising the board on the company’s risk appetite, reviewing and approving the risk management strategy and advising the board on risk exposures.

Companies face many risks, for example:

- The risk that products become technologically obsolete.
- The risk of losing key staff.
- The risk of a catastrophic failure of IT systems.
- The risk of changes in government policy.
- The risk of fire or natural disaster.

Companies need mechanisms in place to identify and then assess those risks. In so doing, companies can rank risks in terms of their relative importance by scoring them with regard to their likelihood and potential impact. This could take the form of a 'risk map'.

A risk map enables the company to assess the likelihood or probability of a risk occurring and the likely impact to the company.



Once identified and assessed, the company must decide on appropriate ways to manage those risks.

Risk management can involve:

- Transferring the risk to another party e.g. by buying insurance or outsourcing part of the business.
- Avoiding the risk by ceasing the risky activity.
- Reducing the risk by implementing effective systems and controls.
- Accepting the risk and bearing the cost and consequence if the risk happens. This may be likely for risks which are deemed low in terms of probability or impact to the company.

A risk that ranked as highly likely to occur and high potential impact to the business would be prioritised as requiring immediate action. A risk that was considered both low likelihood and low impact might be ignored or insured against.

Internal controls and risk management

One way of minimising risk is to incorporate internal controls into a company's systems and procedures.

Director's responsibilities in respect of risk

It is the director's responsibility to implement internal controls and monitor their application and effectiveness.

The risks considered by management are numerous. They come from both external (environmental) and internal (operational) sources.

The main aim of risk management is to protect the business from unforeseen circumstances that could negatively impact the profitability of the company and stop it achieving its strategic goals.

Auditor's responsibilities in respect of risk

Auditors are not responsible for the design and implementation of their clients' control systems. Auditors have to assess the effectiveness of controls for reducing the risk of material misstatement of the financial statements. They incorporate this into their overall audit risk assessment, which allows them to design their further audit procedures.

In addition to this, in accordance with ISA 265 *Communicating Deficiencies in Internal Control to Those Charged With Governance and Management*, auditors are required to report significant deficiencies in client controls and any significant risks identified during the audit to those charged with governance.

Remuneration

Principles

- Remuneration should be designed to promote the long-term sustainable success of the company. Executive remuneration should be aligned to the company purpose, values and long-term strategy.
- The board should establish formal and transparent procedures for developing the policy for executive directors' remuneration.
- No director should be involved in setting his/her own pay.
- Directors should exercise independent judgement and discretion when authorising remuneration, taking account of company and individual performance, and wider circumstances.

Main provisions

- A remuneration committee comprising a minimum of three independent NEDs should be established.
- The chair of the board cannot chair the remuneration committee and can only be a member of the committee if they were independent on appointment.
- The remuneration committee should determine the policy for executive director remuneration and set remuneration for the chair, executive directors and senior management.
- The committee should review workforce remuneration and related policies taking these into account when setting the policy for executive director remuneration.
- NED remuneration should be determined by the board. It should reflect time commitment and responsibilities of the role and should not include share options or other performance related elements.
- Remuneration schemes should promote long-term shareholdings by executive directors. Shares awards should be released for sale on a phased basis and be subject to a total vesting and holding period of five years or more.
- Remuneration schemes should include provisions that enable a company to recover or withhold sums or share awards and specify the circumstances in which it would be appropriate to do so.
- Only basic salary should be pensionable and pension contribution rates should be aligned with those available to the workforce.
- Notice or contract periods should be one year or less. If it is necessary to offer longer periods to new directors the period should reduce to one year or less after the initial period.
- When determining the executive director remuneration policy and practices the committee should ensure remuneration arrangements are transparent, easy to understand, predictable, proportionate, and aligned to culture. The risks from excessive rewards should be identified and mitigated and the range of possible values of rewards should be identified and explained at the time of approving the policy.
- The work of the remuneration committee should be described in the annual report.

Remuneration committee
The role of the remuneration committee is to set the remuneration packages for the chair, executive directors and senior management. This is to ensure that they are paid fairly, but not excessively.

Advantages

- Decisions are based on agreement of several people, reducing the risk of bribes from directors in return for a higher package.
- No director is involved in setting their own pay which could lead to excessive amounts being paid.
- Long-term performance related elements will be included to avoid the risk that directors are rewarded for poor performance or rewarded for taking decisions which may have a positive outcome in the short-term but would not be good for long-term success of the company.

3 Relevance of corporate governance to external auditors

If a company complies with corporate governance best practice, the control environment of the company is likely to be stronger. There will be a greater focus on financial reporting and internal controls which should reduce control risk and inherent risk which together reduce the risk of material misstatements in the financial statements. In some jurisdictions, external auditors are required to report on whether companies are compliant with corporate governance principles.

There is significantly more communication between audit committees and external auditors in the current environment. If the company, including the audit committee, demonstrates good corporate governance, this should result in the company taking more responsibility for its actions, the independence of the auditor being greater, and the overall quality of the audit being higher.

Auditor reporting responsibilities

ISA (UK) 700 requires the auditor to report by exception in the auditors' reports of companies disclosing compliance with the UK Corporate Governance Code where the annual report includes:

- A statement given by the directors that they consider the annual report and accounts taken as a whole is fair, balanced and understandable and provides the information necessary for shareholders to assess the entity's performance, business model and strategy, that is inconsistent with the knowledge acquired by the auditor in the course of performing the audit.
- A section describing the work of the audit committee that does not appropriately address matters communicated by the auditor to the audit committee.
- An explanation, as to why the annual report does not include such a statement or section that is materially inconsistent with the knowledge acquired by the auditor in the course of performing the audit.
- Other information that, in the auditor's judgement, contains a material inconsistency.

Other countries may have different reporting requirements in accordance with local legislation and regulations.

Test your understanding 1

The directors of Murray Co are interested in being able to report that they comply with best practice corporate governance principles and have asked for your thoughts.

The finance director has provided you with the following information:

The board consists of the chief executive officer, finance director, HR director, production director and sales director. The aunt and uncle of the chief executive officer were appointed as non-executive directors last year. Previously they ran their own small cafe and used a firm of accountants for all financial matters due to their own lack of expertise in that area.

The contracts signed by the non-executive directors state that they are in place until they decide to leave or unless they are found guilty of misconduct. They receive an annual fee and a number of share options in Murray Co as their remuneration.

Since appointment, the two non-executives have formed an audit committee consisting of themselves and the human resources director as it was felt that the finance director would not be an independent member of the committee.

They have also formed a remuneration committee with the finance director and are currently in the process of proposing and approving the salaries for all of the directors for the coming year.

Required:

(a) Explain whether Murray Co is required to comply with a code of corporate governance.

(b) Explain the strengths of Murray Co's current governance arrangements.

(c) Identify and explain the weaknesses in Murray Co's current governance arrangements and for each weakness recommend an action the company should take to remedy the weakness.

Test your understanding 2

You are the audit manager of Tela & Co, a medium sized firm of accountants. Your firm has just been asked for assistance from Jumper & Co, a firm of accountants in an adjacent country. This country has just implemented the internationally recognised codes on corporate governance and Jumper & Co has a number of clients where the codes are not being followed. One example of this, from SGCC, a listed company, is shown below. As your country already has appropriate corporate governance codes in place, Jumper & Co has asked for your advice regarding the changes necessary in SGCC to achieve appropriate compliance with corporate governance codes.

Extract from financial statements regarding corporate governance:

Jiang Sheppard is the chief executive officer and board chair of SGCC, with responsibility for appointing and maintaining a board of five executive directors and two non-executive directors. While the board sets performance targets for the senior managers in the company, no formal targets are set for the board and no review of board policies is carried out. Board salaries are therefore set and paid by Jiang Sheppard based on their assessment of all the board members, including their own, and not their actual performance.

Internal controls in the company are monitored by the senior accountant, although a detailed review is assumed to be carried out by the external auditors. SGCC does not have an audit committee or an internal audit department.

Annual financial statements are produced, providing detailed information on past performance.

Required:

(i) Explain SIX corporate governance deficiencies in SGCC, and

(ii) Recommend the changes necessary to overcome each deficiency. (12 marks)

Test your understanding 3

Cocklebiddy Co, a listed company, is currently reviewing its corporate governance practices to ensure they are compliant with regulations. The following is a description of the corporate governance policies they have in place:

- A remuneration committee comprising 3 non-executive directors.
- An audit committee comprising the finance director, the chief executive and 2 non-executive directors.
- Separate people taking on the roles of chair and chief executive.

1 **Which of the following best defines Corporate Governance?**

A Corporate governance refers to the importance a company attaches to systems and controls.

B Corporate governance is the means by which a company is operated and controlled.

C Corporate governance is the extent to which a company is audited, both internally and externally.

D Corporate governance is an appraisal activity as a service to the entity.

2 **In terms of the structure of the audit committee of Cocklebiddy Co, which of the following actions should be taken to become compliant with corporate governance regulations?**

A A minimum of one non-executive director should be recruited

B A minimum of one non-executive director should be recruited and the finance director should be removed

C A minimum of one non-executive director should be recruited and the finance director and chief executive should be removed

D No action necessary

3 **Which TWO of the following are functions of audit committees?**

(i) Planning the annual external audit.

(ii) Reviewing the effectiveness of internal financial controls.

(iii) Reviewing and monitoring the external auditor's independence.

(iv) Processing year-end journal adjustments to the financial statements.

A (i) and (iv)

B (i) and (iii)

C (ii) and (iv)

D (ii) and (iii)

4 **Cocklebiddy Co does not currently have an internal audit function. Which of the following summarises the requirements of corporate governance regulations in respect of internal audit?**

A The audit committee must review the need for an internal audit function on an annual basis

B The audit committee must establish an internal audit committee as soon as possible

C There must either be an audit committee or internal audit function in place but there is no requirement to have both

D The finance director must review the need for an internal audit function and should make a request to the audit committee if it is decided that an internal audit function would be beneficial

5 **Which of the following is the main purpose of the remuneration committee?**

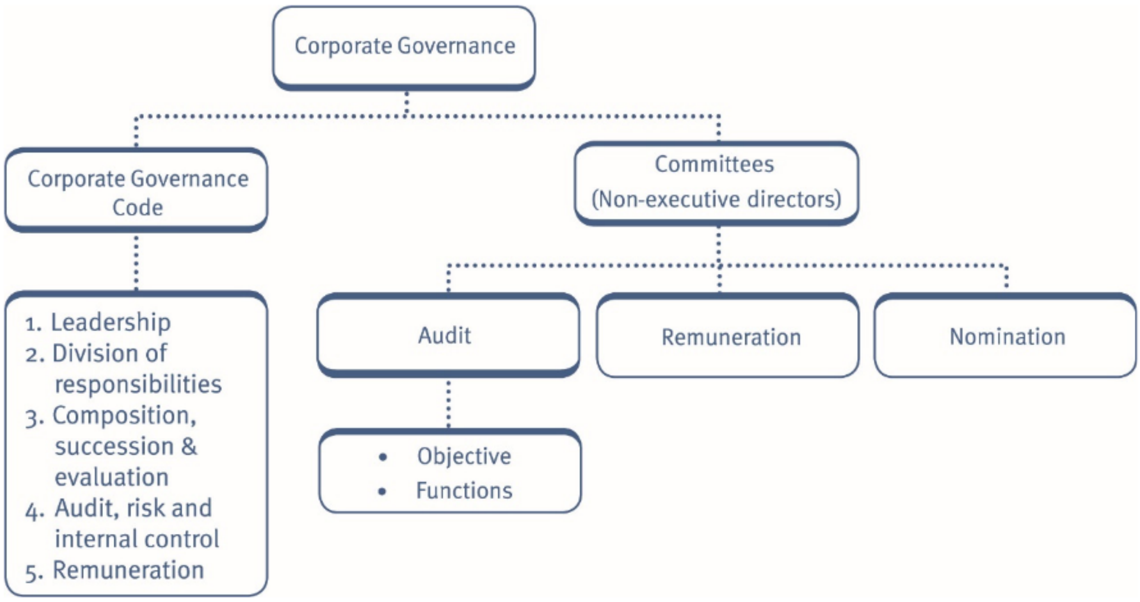
A To ensure that the costs of the company are kept under control

B To ensure no director is involved in setting his/her own pay and the pay that is set is at an appropriate level

C To ensure decision making power for the company is not concentrated in the hands of one individual

D To ensure executives' pay is not performance related to reduce the risk of manipulation

4 Chapter summary



Test your understanding answers

Test your understanding 1

(a) As Murray Co is not yet listed on a stock exchange, it is unlikely to be required to comply with a code of corporate governance. It may wish to voluntarily comply in order to send out a positive signal to stakeholders about how the company is managed and governed.

Once the company is listed on a stock exchange it will need to become fully compliant.

(b) The company does have some NEDs who will bring an independent view to decision making and will have the power to balance the views of the executive directors.

It has established an audit committee. This means that there is a group of people focused on all accounting, financial reporting and auditing matters within the company.

There is also a remuneration committee which will bring some independence and fairness into the decisions on salaries and rewards of the directors.

(c)

Weakness	Recommendation
There are not enough non-executive directors. Corporate governance principles require the board to be balanced, and currently the executive directors outweigh the NEDs. This means that the executives could ensure all of their proposals are passed at board meetings which reduces the effectiveness of the NEDs.	At least three more NEDs need to be recruited to ensure a balanced board.

There does not appear to be a chair. Corporate governance principles require that there is an independent chair to run the board and a chief executive in charge of running the company. This is to ensure there is not too much power in the hands of one person and so these two roles cannot be fulfilled by the same person.	An independent person should be appointed as chair.
The current NEDs do not appear to be independent. Independent NEDs will be more likely to challenge the decisions of the executive directors. As the two current NEDs are related to the CEO, it is unlikely they would challenge any decisions making them ineffective.	The two NEDS need to be replaced by independent people.
The NEDs appear to have a continuous contract. In order to make sure they work in the company's best interests, all directors should be subject to re-election at regular intervals. This does not appear to be the case here.	All directors should be subject to re-election on an annual basis.
The NEDs have share options as part of their remuneration. Corporate governance principles make it clear that in order to maintain their independence, NEDs should be paid a flat fee for their services based on the time commitment and responsibilities of the role. It should not be related to company performance.	All new NED contracts should have remuneration based on time commitment and responsibilities of the role.

An executive director sits on the audit committee. The sub-committees must be independent to ensure effectiveness, and so it is required that only NEDs sit on the audit committee.	The HR director should be removed from the audit committee and one of the newly appointed independent NEDs should take their place.
Nobody on the audit committee has financial experience. In order to provide valuable input into the accounting and auditing process, at least one member of the audit committee should have financial experience.	When recruiting the new NEDs, the company should look for at least one person with a financial background to sit on the audit committee.
An executive director sits on the remuneration committee. It is a requirement of corporate governance principles that no director should be involved in setting their own remuneration as this could lead to excessive pay being awarded.	The finance director should be removed from the remuneration committee and one of the newly appointed NEDs should take their place. The remuneration committee should set the salaries for the executives, senior management and chair. The board should determine the remuneration of the NEDs.

Test your understanding 2

Why the corporate governance code is not met and why this may cause problems	Recommendation
Jiang Sheppard is chief executive and chair of the company. Jiang Sheppard has too much power over the key decisions of the company.	An independent person should be appointed as chair.
The board ratio is 5:2 in favour of the executive directors. Executive directors can dominate board decisions which may not be in the best interests of the shareholders.	Three more NEDs should be appointed to balance the board.

Jiang Sheppard appoints all directors to the board. Jiang Sheppard may appoint directors who will support their voting at board decisions. There may be no clear and transparent process for determining appointments.	A nomination committee comprising a majority independent NEDs should be established to appoint directors and ensure there is no bias.
Jiang Sheppard sets the pay of the directors as well as setting their own pay. Jiang Sheppard may pay directors more if they agree to support their decisions. They may pay more than they should.	A remuneration committee comprising independent NEDs should be established to set the pay of the executive directors. The committee should make sure the pay promotes long-term, sustainable success.
The board's performance is not reviewed. If performance is not reviewed there is no accountability for poor performance. The board may not be as effective as it could be at maximising shareholder wealth.	Performance targets should be set and performance against these targets monitored on a regular basis. Directors should be required to explain any under-performance.
It is believed that the external auditor monitors the internal controls. The external auditor will only look at controls relevant to the audit but this cannot be relied upon to determine the effectiveness of the internal control systems across the company.	The audit committee should consider the need for an internal audit function. If the audit committee considers an internal audit function is not required they should describe in the annual report how internal assurance is achieved.
There is no audit committee. Corporate governance codes require an audit committee to be established to take responsibility for the oversight of financial reporting and audit matters.	An audit committee should be established comprising independent NEDs and they will be the main point of contact for internal auditors and external auditors.

Test your understanding 3

1	B	Corporate governance refers to the means by which a company is operated and controlled.
2	C	The audit committee should comprise 3 independent non-executive directors. The chief executive and finance director should not be members of the audit committee. In addition, it should be confirmed that the NEDs currently sitting on the audit committee are independent.
3	D	Reviewing the effectiveness of internal financial controls and reviewing and monitoring the external auditor's independence.
4	A	There is no requirement for a company to have an internal audit function. The audit committee should review the need for one on an annual basis if the company does not have one.
5	B	Remuneration should be sufficient to attract, retain and motivate but should not be excessive. Directors should not be involved in setting their own pay. Performance related remuneration is encouraged but should promote the long-term sustainable success of the company.

Chapter

4

Ethics and acceptance

Chapter learning objectives

This chapter covers syllabus areas:

- A4 – Professional ethics and ACCA's Code of Ethics and Conduct
- B1 – Obtaining, accepting and continuing audit engagements

Detailed syllabus objectives are provided in the introduction section of the text book.

PER

One of the PER performance objectives (PO1) is ethics and professionalism. The fundamental principles of ethical behaviour mean you should always act in the wider public interest. You need to take into account all relevant information and use professional judgement, your personal values and scepticism to evaluate data and make decisions. You should identify right from wrong and escalate anything of concern. You also need to make sure that your skills, knowledge and behaviour are up-to-date and allow you to be effective in your role. Working through this chapter should help you understand how to demonstrate that objective.

This chapter further develops the ethical principles covered in Business Technology (previously Accountant in Business) at the Applied Knowledge level.

1 The need for professional ethics

Practitioners need to **behave, and be seen to behave,** in an ethical, professional manner. This means taking active steps to act in an ethical manner in every professional situation.

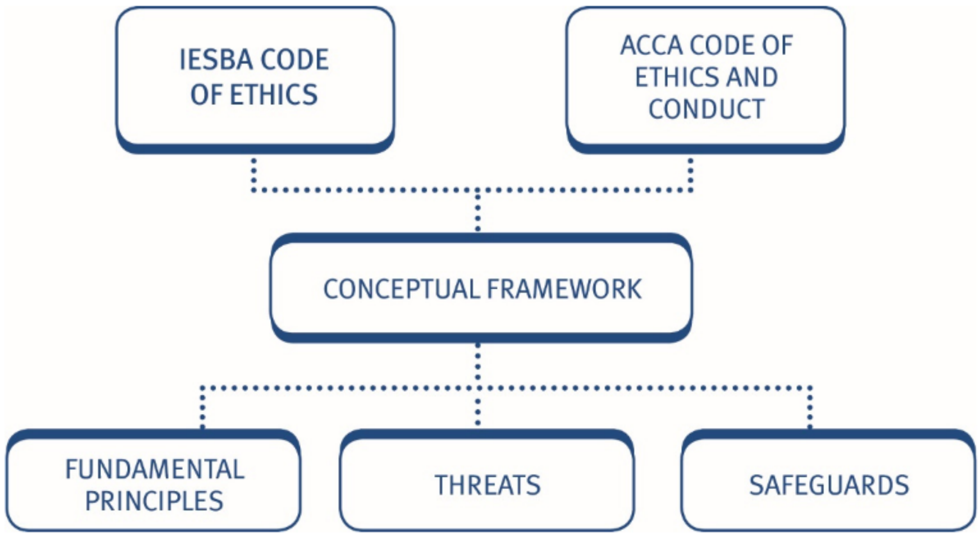
Professional accountants have a responsibility to act in the public interest. The purpose of assurance engagements is to increase the confidence of the intended users; therefore, the users need to trust the professional who is providing the assurance.

In order to be trusted the assurance provider needs to be independent of their client.

Independence can be defined as having 'freedom from situations and relationships where objectivity would be perceived to be impaired by a reasonable and informed third party.'

Reasonable and informed third party
The reasonable and informed third party does not need to be an accountant, but has enough relevant knowledge and experience to understand and evaluate the appropriateness of the accountant's conclusions in an impartial manner.

2 The IESBA and ACCA codes and the conceptual framework



IFAC, through the IESBA, has issued a code of ethics, as has the ACCA. The ACCA Code of Ethics and Conduct is covered in this chapter. However, both of these Codes have the same roots and are, to all intents and purposes identical.

Both follow a conceptual framework which identifies:

- Fundamental principles of ethical behaviour
- Potential threats to compliance with these fundamental principles
- Possible safeguards which can be implemented to eliminate the threats identified, or reduce them to an acceptable level.

Ethical guidance can take either a principles-based approach or rules-based approach.

A conceptual framework relies on a principles-based approach.

Both IESBA and ACCA adopt a principles-based approach.

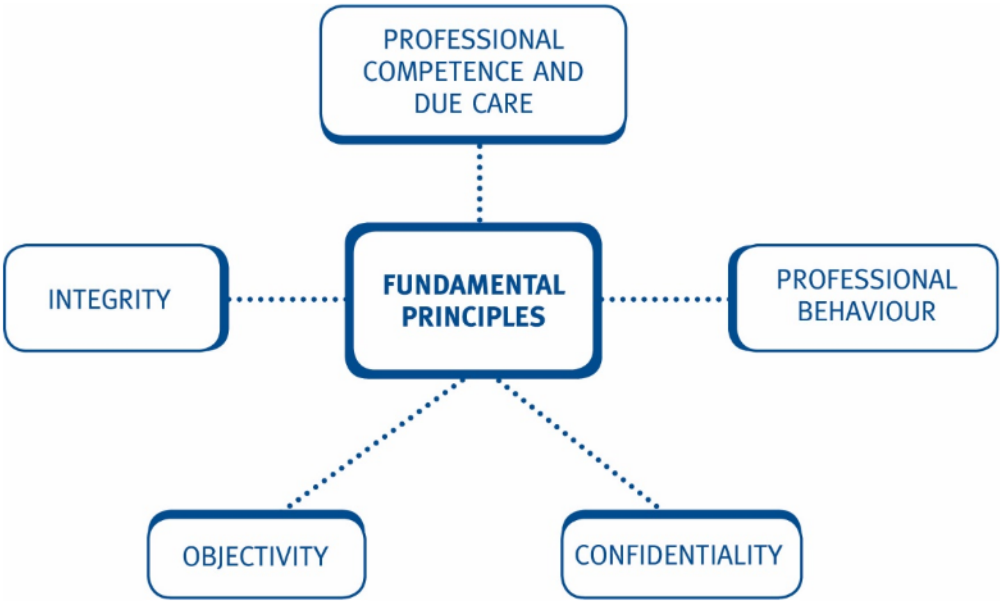
Principles-based approach	Rules-based approach
• Requires compliance with the spirit of the guidance. • Requires the accountant to use professional judgement. • Flexible, so can be applied to new, unusual or rapidly changing situations. • Principles may be applied across national boundaries where laws may not. • Can still incorporate specific rules for ethical situations likely to affect many firms.	• May be easier to follow because rules are clearly defined. • Needs frequent updating to ensure the guidance applies to new situations. • May encourage accountants to interpret requirements narrowly in order to get around the spirit of the requirements. • Virtually impossible to be able to deal with every situation that may arise, particularly across various national boundaries and in a dynamic industry.

Consequences

Practitioners should apply the spirit of the code in everyday practice. Professional bodies such as the ACCA have the right to discipline members who fail to comply with the code of ethics through a process of disciplinary hearings which can result in:

- Fines
- Suspension of membership
- Withdrawal of membership.

3 The fundamental principles



The fundamental principles establish the standard of behaviour expected of a professional accountant.

- **Objectivity:** A professional accountant must exercise professional or business judgement without being compromised by bias, conflicts of interest or undue influence of, or undue reliance on, individuals, organisations, technology and other factors.
- **Professional behaviour:** A professional accountant must comply with relevant laws and regulations, behave in a manner consistent with the profession's responsibility to act in the public interest in all professional activities and business relationships, and avoid any conduct that might discredit the profession.
- **Professional competence and due care**: A professional accountant must attain and maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional services based on current developments in practice, legislation and techniques.

  A professional accountant must act diligently and in accordance with applicable technical and professional standards.
- **Integrity:** A professional accountant must be straightforward and honest in all professional and business relationships. This involves fair dealing, truthfulness and having strength of character to act appropriately in all situations.

- **Confidentiality:** A professional accountant must respect the confidentiality of information acquired as a result of professional and business relationships.

  They should not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose. Such confidential information should not be used for the personal advantage of members or third parties.

[ACCA Code of Ethics and Conduct, Section 110]

e.g

Illustration 1 – Fundamentals principles

The following are real précis hearings held and decisions made and published by the ACCA Disciplinary Committee.

1 A member was found guilty of misconduct because they signed the auditor's report without conducting any audit work, contrary to the fundamental principle of **integrity**.

2 A member was found guilty of misconduct because they failed to advise a client to have an audit when an audit was required by law, contrary to the fundamental principle of **professional competence and due care**.

3 A member was found guilty of misconduct because they 'failed to reply to correspondence sent by a third party and ACCA' contrary to the fundamental principle of **professional behaviour**.

4 A member was found guilty of misconduct because they 'lost possession of a client's books and records to a third party' contrary to the fundamental principle of **confidentiality**.

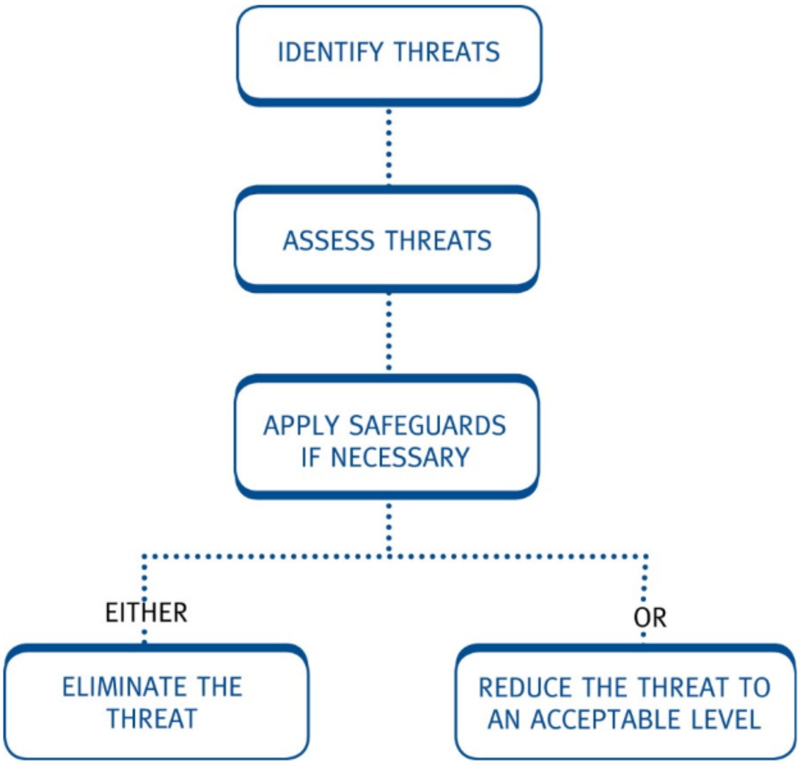
5 A member was found guilty of misconduct because they 'carried out an audit of a company' in which they owned shares 'without implementing appropriate safeguards' contrary to the fundamental principle of **objectivity**.

As a result, a combination of the following sanctions were ordered by the ACCA Disciplinary Committee in each case:

- Suspension of membership
- Exclusion from ACCA
- A fine
- Ordered to pay costs
- Publication of the results of the decision and the member's name on the ACCA website
- Publication of the results of the decision and the member's name in the local press.

4 Threats and safeguards

Firms must establish procedures to:



A **safeguard** is an action or measure that eliminates a threat, or reduces it to an acceptable level.

Identifying threats

Self-interest threats

Where the auditor has a financial or other interest that will inappropriately influence their judgement or behaviour.

Fee dependency

Self-interest and intimidation threats can be created if the total fees generated from one audit client represent a large proportion of the total fees of the firm, or represent a large proportion of the revenue of one partner or office of the firm. [410.14 A1, A5]

Over-dependence could lead the auditor to ignore adjustments required in the financial statements for fear of losing the client.

Factors relevant when evaluating the threat include:

- Operating structure of the firm
- Whether the firm is expected to diversify to reduce dependence
- The significance of the client to the firm
- The extent to which the compensation of the partners is dependent on the fees generated from the client.

[410.14 A4, A6]

Non-listed clients

- A firm's independence is threatened if total fees from an audit client exceed 30% of the firm's total fees for five consecutive years.
- An engagement quality review should be performed. This can be either a pre-issuance review, before the 5th year audit opinion is issued by a person not a member of the audit firm expressing the opinion, or a post-issuance review on the 5th year audit before the 6th year audit opinion is issued by a person not a member of the audit firm expressing the opinion, or by the professional regulatory body.

[R410.15]

If fees from an audit client represent a large proportion of the firm's total fees, the firm should implement safeguards such as:

- Reducing the extent of other services provided to the client.
- Increasing the client base or services provided to other clients to reduce dependency.
- Having an appropriate reviewer who is not a member of the firm review the work.
- Ensuring partner compensation is not significantly influenced by client fees.

[410.14 A4, A7]

For a joint audit arrangement, where two or more firms are engaged to conduct the audit, the involvement of the other firm can be considered a safeguard provided the fee dependency applies to only one firm and each firm performs sufficient work to take full responsibility for the audit opinion. [R410.17]

Listed clients

- A firm's independence is threatened if total fees from a listed audit client exceed 15% of the firm's total fees for two consecutive years. [R410.18]
- An engagement quality review should be performed by a person not a member of the audit firm expressing the opinion prior to the 2nd year audit opinion being issued. [R410.18]
- If fees remain at this level for five consecutive years, the firm must resign as auditor after the audit opinion on the 5th year is issued. An exception may be made if the professional body considers it would be in the public interest for the firm to continue. In this case, a pre-issuance review must be performed before the opinion on the 6th (and any subsequent) years financial statements is issued. [R410.20, 21]

For a joint audit arrangement, where two or more firms are engaged to conduct the audit, the involvement of the other firm can be considered a safeguard provided the fee dependency applies to only one firm and each firm performs sufficient work to take full responsibility for the audit opinion. [R410.19]

Gifts and hospitality

Acceptance of goods, services or hospitality from an audit client can create self-interest, intimidation and familiarity threats as the auditor may feel indebted to the client.

Gifts and hospitality may not be accepted unless the value is trivial and inconsequential. [R420.3]

Gifts and hospitality which are trivial and inconsequential but which are intended to improperly influence the behaviour of the recipient should not be accepted. [420.3 A2]

e.g

Gifts and hospitality

A client offers to take the audit team out for an expensive meal. This creates a self-interest threat. Matters to consider before accepting or rejecting the offer include whether the meal is before or after the auditor’s report has been signed. If before, the offer of the meal could be intended to influence the outcome of the audit.

Owning shares/financial interests

The auditor will want to maximise return from the investment and overlook audit adjustments which would affect the value of their investment.

When evaluating the threat, the factors which should be considered include who holds the financial interest and whether the financial interest is direct or indirect.

A direct, or material indirect, financial interest in the audit client must not be held by:

- the firm or a network firm
- an audit team member or the immediate family of a team member
- a partner working in the office connected with the audit engagement partner
- any partner providing non-audit services to the audit client.

[R510.4]

An immediate family member may hold a financial interest such as pension or share options but must dispose of it as soon as practicable when the family member has the right to do so, e.g. when there is a right to exercise the option. [R510.5]

Financial interests received indirectly e.g. by inheritance or gifted, must be disposed of immediately. [R510.9]

If a close family member of an audit team member holds a direct, or material indirect financial interest in an audit client, the person must be removed from the team until the financial interest is disposed and an appropriate review of the work must be performed. [510.10 A7 – A8]

Loans and guarantees

The significance of the threat depends on whether the loan or guarantee is with a bank or similar financial institution and whether the amount is material.

Loans and guarantees to audit clients are not permitted unless immaterial to the firm or individual making the loan or guarantee, and the client. [R511.4]

Loans and guarantees between an audit client which is a bank or similar financial institution and the firm, the audit team member, or their immediate family, that are not made under normal lending procedures, terms and conditions are not permitted. [R511.5]

If a material loan from a bank or similar financial institution is obtained under normal lending procedures, terms and conditions, the work should be reviewed by an appropriate reviewer, who is not an audit team member, from a network firm that is not a beneficiary of the loan. [R511.5.A3]

A loan or guarantee from an audit client which is not a bank or financial institution is not permitted unless immaterial. [R511.7]

e.g **Loan offered to an audit team member**

An audit team member working on the audit of a bank is offered a loan at a preferential rate due to their involvement with the audit. The loan must be declined as it would not be offered under commercial terms and conditions available to everyone, therefore could affect the judgement of the auditor.

Overdue fees

A self-interest threat may be created if fees payable by an audit client are overdue during the audit engagement. The firm is expected to obtain payment before the auditor's report is issued. [410.12 A1, A2]

The firm may treat the client favourably to ensure the fees are paid.

Factors which should be considered when evaluating the threat include the value of the debt, how long the debt has been outstanding and the ability and willingness of the client to pay the overdue fees. [410.12 A3]

To manage the threat the firm should:

- Obtain partial or full payment for the fees.
- Have an appropriate reviewer who did not take part in the audit review the work performed.

[410.12 A4]

When fees remain overdue for a significant amount of time, the firm should consider whether the overdue fees constitute a loan, and whether it is appropriate to seek reappointment or continue with the engagement. [R410.13]

Business relationships

If audit firms (or members) enter into business relationships with clients (e.g. joint ventures, combining products or services of each party, distribution or marketing arrangements), this leads to self-interest because the auditor would have an interest in the successful operation of the client.

A firm, network firm or audit team member should not have a close business relationship with an audit client unless any financial interest is immaterial and the business relationship is insignificant to the client, the firm or the audit team member. [R520.4]

Factors to consider when evaluating the threat include whether the purchase is in the normal course of business and the materiality of the purchase(s).

The purchase of goods and services from an assurance client does not normally give rise to a threat to independence, provided the transaction is in the normal course of business and on commercial terms. [520.6 A1]

If the purchase of goods and services by an audit team member represents a material amount, that person should be removed from the audit team or they should reduce the magnitude of the transactions. [520.6 A2]

Potential employment with an audit client

If a member of the engagement team has reason to believe they may become an employee of the client they will not wish to do anything to affect their potential future employment.

The firm must establish policies and procedures which require individuals to notify the firm of the possibility of employment with the client. [R524.5]

When such a situation occurs, the following safeguards should be implemented:

- Remove the individual from the assurance engagement. [524.5 A2]
- Have an appropriate reviewer review any significant judgements made by that individual. [524.5 A3]

Contingent fees

The auditor would have incentive to ensure a particular outcome is achieved in order to maximise the audit fee. E.g. overlook audit adjustments that would reduce profit if the fee is calculated based on profit.

Fees based on a particular outcome, e.g. level of profits of the company, are not permitted for audit engagements. [R410.9]

Contingent fees are not permitted for non-assurance services provided to an audit client if:

- The fee is material to the firm.
- The outcome of the non-assurance service is dependent on a future judgement related to the audit of a material amount in the financial statements.

[R410.10]

e.g

Contingent fee

The finance director of Rain Co has suggested that the audit fee is based on the profit before tax of the company.

The audit firm will not be able to accept contingent fees and should communicate to those charged with governance at Rain Co that the external audit fee needs to be based on the time spent and levels of skill and experience of the required audit team members.

Compensation and evaluation policies

A self-interest threat is created when a member of the audit team is evaluated on, or compensated for, selling non-assurance services to that audit client.

The significance of the threat will depend on:

- The proportion of the individual's compensation or performance evaluation that is based on the sale of such services.
- The role of the individual on the audit team.
- Whether promotion decisions are influenced by the sale of such services.

[411.3 A1]

Audit team members

The firm shall:

- Revise the compensation plan or evaluation process for that individual.
- Remove that individual from the audit team.
- Have an appropriate reviewer review the work of the member of the audit team.

[411.3 A2 – A3]

Key audit partners

A key audit partner shall not be evaluated on or compensated based on their success in selling non-assurance services to their audit client.
[R411.4]

Actual or threatened litigation

Litigation could represent a breakdown of trust in the relationship between auditor and client. This may affect the impartiality of the auditor, and lead to a reluctance of management to disclose relevant information to the auditor.
[430.3 A1]

The significance of the threat depends on the materiality of the litigation and whether the litigation relates to a prior assurance engagement. [430.3 A2]

It may be possible to continue other assurance engagements, depending on the significance of the threat by:

- Discussing the matter with the client. [430.3 A1]
- If the litigation involves an individual, removing that individual from the engagement team. [430.3 A3]
- Having an appropriate reviewer review the work performed. [430.3 A4]

If adequate safeguards cannot be implemented the firm must withdraw from, or decline, the engagement.

Familiarity threats

When the auditor becomes too sympathetic or too trusting of a client and loses professional scepticism, or where the relationship between the auditor and client goes beyond professional boundaries.

Long association of senior personnel

Using the same senior personnel in an engagement team over a long period may cause the auditor to become too trusting/less sceptical of the client resulting in material misstatements going undetected.

A self-interest threat may also be created as a result of the individual's concern about losing a longstanding client. [540.3. A2]

In relation to the individual the firm should consider:

- The length and closeness of the individual's relationship with the client.
- The length of time on the audit team.
- The extent of direction, supervision and review of work of the individual.
- The extent to which the individual has had the ability to influence the outcome of the audit.
- The nature, frequency and extent of interaction between the individual and the client.

[540.3 A3 (a)]

In relation to the audit client, the firm should consider:

- Whether the complexity of the subject matter has changed.
- Whether the client's management team has changed.
- Structural changes in the client's organisation.

[540.3 A3 (b)]

Safeguards which can be implemented for all clients:

- Rotate individuals off the audit team.
- Change the role of the individual or the nature of the tasks they perform.
- Have an appropriate reviewer who was not a member of the audit team review the work performed.
- Perform regular independent internal or external quality reviews of the engagement.

[540.3 A5 – A6]

Listed clients

The engagement partner, EQR or any other key audit partner must not act for a period of more than seven cumulative years ('time-on' period).

After the time-on period, the individual must serve a cooling-off period.

[R540.5]

The cooling-off periods are as follows:

- 5 years for an engagement partner.
- 3 years for an EQR.
- 2 years for a key audit partner.

[R540.11 – 13]

During the cooling-off period, the individual shall not:

- Be an engagement team member.
- Consult with the engagement team or client.
- Be responsible for, or provide, other professional services to the audit client.
- Undertake any role which would require significant interaction with senior management or directly influence the outcome of the audit.

[R540.20]

In exceptional circumstances, a key audit partner may be permitted to serve a one-year extension if continuity is important to maintain audit quality. [R540.7]

If an audit client becomes a public interest entity, the length of time served as a key audit partner before the client became a public interest entity is taken into account. [R540.8]

If a key audit partner was a key audit partner on that engagement at a different firm, the length of time served at the prior firm should be taken into account. [R540.18]

An independent regulatory body may provide an audit firm with an exemption from partner rotation if the firm does not have sufficient people with the necessary knowledge and experience to enable partner rotation. [R540.9]

e.g

Long association

Martine served as the audit engagement partner for Matteous Co, a listed entity, for five years before taking a career break of two years. On return to the audit firm, Martine is assigned as the audit engagement partner to Matteous Co again. As the minimum cooling-off period has not passed, Martine can only serve for a further two years, taking the total up to seven years, after which, a cooling-off period of five years must pass before Martine can be involved again with the audit of Matteous Co.

Sam has been the audit engagement partner for Frambois Co for three years when the company becomes listed. Sam can remain as partner for a further four years, as the three years served prior to the listing are taken into account when determining the rotation period.

Family and personal relationships

A familiarity threat (and self-interest or intimidation threat) may occur when a member of the engagement team has a family or personal relationship with someone at the client who is able to exert significant influence over the financial statements (or subject matter of another assurance engagement). [521.4 A1]

Factors which should be considered when evaluating the threat include the individual's responsibilities on the audit team and the role of the family member or other individual within the client, and the closeness of the relationship. [521.3 A2]

Audit team members

Where an immediate family member is a director or employee in a position to influence the accounting records or financial statements, the individual must be removed from the engagement team. [R521.5]

Where an immediate family member is in a position to exert influence over the client's financial position, performance or cash flows, or where a close family member is a director or employee in a position to influence the accounting records or financial statements, the following safeguards can be applied:

- Remove the individual from the audit team.
- Structure the engagement team so that the individual does not deal with matters that are the responsibility of the family member.

[521.4 A1, A3, A4 and 521.6 A1, A3, A4]

Other employees and partners of the firm

A firm should have policies and procedures in place to provide guidance when a partner (or employee) of the firm has a family or personal relationship with someone at the client who is able to exert significant influence over the subject matter, even when the individual is not a member of the engagement team. [R521.8]

The firm should structure the individual's responsibilities to reduce any potential influence over the audit engagement and have an appropriate reviewer review the audit work performed. [521.8 A2]

Recruitment services

Familiarity, self-interest or intimidation threats may arise if the firm is involved in recruiting senior personnel for the client.

The firm may also be considered to be assuming management responsibilities.

Reviewing qualifications and interviewing applicants to advise on financial competence is allowed. [609.4 A2]

Recruitment services may be provided to an audit client provided the client makes all management decisions including determining the suitability of the candidate, selecting a suitable candidate, determining employment terms and negotiating remuneration. [R609.3]

The firm cannot provide recruitment services in respect of directors or senior management who would be in a position to exert significant influence over the financial statements. [R609.6]

Employment with an audit client

A self-interest, familiarity or intimidation threat may arise where an employee or partner of the firm becomes a director or employee of an audit client (in a position to exert significant influence over the financial statements or other subject matter). [524.3 A1]

The firm should ensure no significant connection remains between the individual and the firm, such as entitlement to benefits or payments from the firm, or participation in the firm's business and professional activities.
[R524.4]

The firm should consider:

- The position taken at the client.
- The involvement the person will have with the audit team.
- The length of time since the individual was a member of the audit team.
- The former position of the individual within the audit team.

[524.4 A3]

Former partner or audit team members

Safeguards include:

- Modifying the audit plan.
- Assigning individuals to the audit team who have sufficient experience in relation to the individual who has joined the client.
- Having an appropriate reviewer review the work of the former audit team member.

[524.4 A4]

Partners joining listed clients as a director or employee in a position to exert influence over the financial statements

Independence is compromised unless, subsequent to the partner ceasing to be a key audit partner or senior partner, the client had issued audited financial statements covering a period of not less than 12 months, and the partner was not a member of the audit team with respect to the audit of those financial statements. [R524.6]

If a senior or managing partner of the firm joins a listed audit client, independence is compromised unless twelve months have passed since the individual was the senior or managing partner. [R524.7]

Self-review threats

Where non-audit work is provided to an audit client and is then subject to audit, the auditor will be unlikely to admit to errors in their own work, or may not identify the errors in their own work.

Accounting and bookkeeping services

Providing accounting and bookkeeping services for an audit client might create a self-review threat.

Accounting and bookkeeping services include:

- Preparing accounting records and financial statements including:
  - determining accounting policies
  - originating or changing journal entries
  - determining account classifications of transactions
- Recording transactions
- Payroll services.

[601.3 A1]

Discussing accounting treatments and proposing adjusting journal entries are a normal part of the audit process and do not create threats as long as the client is responsible for making decisions in the preparation of the financial statements.

Non-listed clients

A firm shall only provide a non-listed audit client with accounting and bookkeeping services which are routine or mechanical in nature. [R601.5]

Professionals who are not audit team members must be used to perform the service and an appropriate reviewer who was not involved in providing the service should review the audit work or service performed. [601.5 A3]

Services which are routine and mechanical in nature and therefore require little or no professional judgement include:

- Preparing payroll calculations based on client-originated data.
- Recording recurring transactions which are easily determinable.
- Calculating depreciation when the client determines the accounting policy, useful life and residual value.
- Posting transactions coded by the client to the ledger.
- Posting client approved entries to the trial balance.
- Preparing financial statements based on information in the client-approved trial balance.

[601.5 A2]

Listed clients

A firm cannot provide a listed audit client with accounting and bookkeeping services. [R601.6]

Internal audit services

In addition to the self-review threat, the audit firm must be satisfied that management takes full responsibility for the internal audit activities and internal controls to avoid assuming management responsibilities. [R605.3]

The firm should consider:

- The materiality of the related financial statement amounts.
- The risk of misstatement of the assertions related to the financial statement amounts.
- The degree of reliance that the audit team will place on the internal audit service.

[605.4 A3]

Non-listed clients

Professionals who are not audit team members must be used to perform the internal audit service. [605.5 A1]

Listed clients

A firm cannot provide internal audit services for a listed audit client, where the service relates to internal controls over financial reporting, financial accounting systems, or in relation to amounts or disclosures that are material to the financial statements.
[R605.6]

e.g

Preparation of financial statements

Amaryllis Co, a non-listed entity, has decided to outsource the preparation of its financial statements and has asked its auditors to perform this additional service. Before accepting this engagement, the firm must consider the scope of the work. The firm can accept the work, with safeguards, if the trial balance is created and approved by client management, accounting policies are determined by the client and areas of judgement are considered by the client. The preparation of the financial statements in such a situation will be routine and mechanical. The audit firm would not be able to select accounting policies, determine depreciation rates or other estimates such as the allowance for expected credit losses. If accepted, the accounts preparation service must be performed by non-audit staff. If Amaryllis Co subsequently became listed, the service would no longer be able to be provided.

Tax services

Providing tax services to an audit client might create a self-review and advocacy threat. [604.3 A1]

Tax services include:

- Tax return preparation
- Tax calculations for preparing accounting entries
- Tax planning and advisory services
- Tax services involving valuations
- Assistance in the resolution of tax disputes.

[604.2 A1]

The firm should consider:

- The characteristics of the engagement.
- The level of tax expertise of the client's employees.
- The complexity of the tax regime.

[604.3 A2]

Tax return preparation

Completion of tax returns does **not** usually create a threat as the returns are based on historical information and subject to approval by the tax authority. [604.6 A1]

Tax calculations

Non-listed clients

The firm should use professionals who are not audit team members to perform the service, and an appropriate reviewer who was not involved in providing the service should review the audit work or service performed. [604.9 A2]

Listed clients

The firm must not prepare tax calculations of current or deferred tax for listed audit clients. [R604.10]

Tax planning and advisory services

In addition to the considerations in 604.3 A2, the firm should consider:

- The degree of subjectivity involved.
- Whether the tax treatment is an established practice, supported by a private ruling and cleared by the tax authority.
- Whether the advice will have a material effect on the financial statements.

[604.12 A3]

A firm shall not provide tax planning and advisory services to an audit client when the effectiveness of the tax advice depends on a particular accounting treatment. [R604.13] When providing such services, the firm should: • Use professionals who are not audit team members to perform the service. • Have an appropriate reviewer who was not involved in providing the service to review the audit work or service performed. • Obtain pre-clearance from the tax authorities. [604.14 A1]

Assistance in the resolution of tax disputes

In addition to the considerations in 604.3 A2, the firm should consider:

- The role management plays in the resolution of the dispute.
- The extent to which the outcome of the dispute will have a material effect on the financial statements.
- Whether the advice provided is the subject of the tax dispute.
- The extent to which the matter is supported by tax law, regulation or established practice.
- Whether the proceedings are conducted in public.

[604.22 A1]

Non-listed clients A firm shall not act as an advocate for the audit client before a public tribunal or court in the resolution of a tax matter if the amounts are material to the financial statements. [R604.25] When providing such services, the firm should: • Use professionals who are not audit team members to perform the service. • Have an appropriate reviewer who was not involved in providing the service to review the audit work or service performed. [604.23 A1] **Listed clients** A firm shall not act as an advocate for a listed audit client before a public tribunal or court in the resolution of a tax matter. [R604.26] The firm is allowed to have a continuing advisory role e.g. • Responding to specific requests for information. • Providing factual accounts or testimony about the work performed. • Assisting the client in analysing the tax issues. [604.27 A1]

IT services

IT services may create a self-review threat and also be considered to be assuming management responsibilities.

The firm should consider:

- The nature of the service.
- The nature of IT systems and the extent to which they impact or interact with the client's accounting records or financial statements.
- The degree of reliance that the audit team will place on the IT systems.

[606.4 A3]

The firm can provide IT services which involve:

- Design or implementation of IT systems unrelated to internal controls or financial reporting.
- Implementation of off-the-shelf accounting software that was not developed by the audit firm and does not require significant customisation.

[606.4 A2]

All clients

When providing such services, the firm should use professionals who are not audit team members to perform the service. [606.5 A1]

The audit firm must be satisfied that management takes full responsibility for the IT controls and systems. [R606.3]

Listed clients

A firm shall not provide IT systems services to a listed client that form a significant part of the internal controls over financial reporting or generate information that is significant to the financial statements. [R606.6]

Valuation services

Providing valuation services to an audit client might create a self-review and advocacy threat. [603.3 A1]

The firm should consider:

- The use and purpose of the valuation report, including whether the report will be made public.
- The extent of the client's involvement in determining matters of judgement.
- The degree of subjectivity.
- Whether the valuation will have a material effect on the financial statements.
- The degree of dependence on future events that might create significant volatility in the amounts involved.

[603.3 A2]

Some valuations will not involve significant subjectivity e.g. if the underlying assumptions are established by law or when techniques are widely accepted. [603.4 A1]

Non-listed clients

Valuation services shall not be provided to audit clients if the valuation involves a significant degree of subjectivity and the valuation will have a material effect on the financial statements. [R603.4]

Listed clients

Valuation services should not be provided to listed audit clients if the service will create a self-review threat. [R603.5]

All clients

Where services can be provided:

- Use professionals who are not audit team members to perform the service.
- Have an appropriate reviewer who was not involved in providing the service review the audit work or service performed.

[603.3 A3]

Corporate finance services

Self-review and advocacy threats may be created if a firm:

- Assists an audit client in developing corporate strategies.
- Identifies possible targets for the audit client to acquire.
- Advises on disposal transactions.
- Assists in raising finance.
- Provides structuring advice.

[610.2 A1]

Factors affecting the existence and significance of any threat include:

- The degree of subjectivity involved.
- Whether the outcome will have a material impact on the financial statements.
- Whether the effectiveness of the corporate finance advice depends on a particular accounting treatment.

[610.4 A1]

Prohibited services

- Corporate finance services that involve promoting, dealing in, or underwriting the audit client's shares. [R610.5]

- Corporate finance services where:
  - the effectiveness of the advice depends on a particular accounting treatment or presentation in the financial statements, and
  - the audit team has reasonable doubt as to the appropriateness of the accounting treatment.

  [R610.6]

Where services can be provided:

- Use professionals who are not audit team members to perform the service.
- Have an appropriate reviewer who was not involved in providing the service review the audit work or service performed.

[610.7 A1]

Listed clients

Corporate services cannot be provided to a listed client if a self-review threat would be created. [R610.8]

Legal services

Providing legal services to an audit client might create a self-review and advocacy threat. [608.3 A1]

Legal services can only be provided by legally trained, or authorised, personnel. [608.2 A1]

The firm should consider:

- The materiality of the matter in relation to the financial statements.
- The complexity of the legal matter and the degree of judgement necessary.

[608.5 A1]

Where services are provided, the firm should:

- Use professionals who are not audit team members to perform the service.
- Have an appropriate reviewer who was not involved in providing the service review the audit work or service performed.

[608.6 A1]

A partner or employee of the firm must not act as general counsel for an audit client. [R608.9]

A firm shall not act in an advocacy role for an audit client when the amounts involved are material to the financial statements. [R608.10]

Temporary personnel assignments

The loan of personnel may create a self-review, advocacy and familiarity threat. [525.2]

Staff may be loaned to the client provided:

- The loan period is short.
- The person does not assume management responsibilities.
- The client is responsible for directing and supervising the person.

[R525.4]

Where personnel are loaned to the client, the following safeguards should be implemented:

- Additional review of the work performed by the loaned personnel.
- Not including the loaned personnel on the audit team.
- Not giving the loaned personnel audit responsibility for any function that they performed during the loaned assignment.

[525.3 A1]

Serving as a director or officer of an audit client

A self-review and self-interest threat will be created if an individual from the audit firm serves as a director or officer of an audit client. [523.2]

A partner or employee shall not serve as a director or officer of an audit client. [R523.3]

A partner or employee shall not serve as company secretary for an audit client unless permitted by local legislation, management makes all relevant decisions, and the duties performed are routine and administrative in nature. [R523.4]

Client staff joins audit firm (recent service with an audit client)

A self-interest, self-review, or familiarity threat may arise where an audit team member has recently served as a director or employee of the audit client. [522.2]

When service with the audit client was prior to the period covered by the auditor's report, the significance of the threat will depend on:

- The position the individual held with the client.
- The length of time since the individual left the client.
- The role of the audit team member.

[522.4 A2]

The audit team should not include individuals who during the period covered by the auditor's report have served as a director or employee of the audit client. [R522.3]

When service with the audit client was prior to the period covered by the auditor's report, an appropriate reviewer should review the work performed by the audit team member. [522.4 A3]

e.g

Request for a partner to sit on the audit committee

An audit client has requested that a partner of the audit firm sits on the audit committee to provide financial reporting expertise. As the audit committee is responsible for ensuring the independence of the auditor, agrees the audit fee and recommends to the shareholders which audit firm to appoint, a self-interest and self-review threat will be created.

Advocacy threats

Promoting the position of a client or representing them in some way would mean the audit firm is seen to be 'taking sides' with the client.

Examples include:

- Representing the client in court or in any dispute where the matter is material to the financial statements.
- Negotiating on the client's behalf for finance.
- Loan of personnel from an audit firm to an audit client.
- Providing valuation services to an audit client.
- Providing tax services to an audit client.

Intimidation threats

Actual or perceived pressures from the client, or attempts to exercise undue influence over the assurance provider, create an intimidation threat.

Examples include:

- Fee dependency
- Gifts and hospitality
- Family and personal relationships
- Recruitment services
- Employment with an audit client
- Litigation between the audit firm and client.

5 Confidentiality

External auditors are in a unique position of having a legal right of access to all information about their clients. The client must be able to trust the auditor not to disclose anything about its business to third parties as it could be detrimental to its operations.

Confidential information may be obtained from:

- The firm or employing organisation
- Business relationships i.e. current clients and previous clients
- Prospective clients and employers.

Members of an assurance team should not disclose any information to anyone outside of the engagement team, whether or not they work for the same firm.

Circumstances in which disclosure is permitted or required

Information should only be disclosed with proper and specific authority, or when there is a legal or professional right or duty to disclose.

Disclosure of confidential information should only be made in the following circumstances:

(a) **Disclosure is required by law**

- – Production of documents or other provision of evidence in the course of legal proceedings.
- – Disclosure to the appropriate public authorities of infringements of the law that come to light.

(b) **Disclosure is permitted by law and is authorised by the client or the employer.**

(c) **There is a professional duty or right to disclose, when not prohibited by law**

- – To comply with the quality review of ACCA or another professional body.
- – To respond to an inquiry or investigation by ACCA or a regulatory body.
- – To protect the professional interests of a professional accountant in legal proceedings.
- – To comply with technical standards and ethics requirements.

Factors to be considered before disclosing confidential information include:

- Whether harm could be caused by the disclosure
- Whether all relevant information is known and substantiated
- Whether the information is to be communicated to appropriate recipients.

[ACCA Code of Ethics and Conduct, Subsection 114]

Disclosure of confidential information: specific examples

Permitted or required by law

Where there is a statutory right or duty to disclose, the professional accountant will do so without obtaining permission of the client. The most common offences members are likely to encounter in their professional work are in relation to:

- Fraud or theft including fraudulent financial reporting, falsification or alteration of accounting records or other documents and misappropriation of assets
- Tax evasion
- Money laundering
- Drug trafficking or terrorism
- Insider dealing, market abuse, and bribery
- Offences under company law.

Public interest

An auditor may disclose information if they consider it to be in the public interest. There is no official definition of 'public interest'. The auditor must employ a combination of judgement and legal advice. A good rule of thumb is that if a member of the public could incur physical or financial damage that the auditor could knowingly have prevented, it is likely that the auditor has failed in their public duty.

In determining the need to disclose matters in the public interest the auditor should consider:

- The relative size of the amounts involved and the extent of the likely financial damage
- Whether members of the public are likely to be affected
- The likelihood of repetition
- The reasons for the client's unwillingness to make the disclosures
- The gravity of the matter
- Relevant legislation, accounting standards and auditing standards
- Legal advice obtained.

The auditor will be protected from the risk of liability provided that disclosure is made in the public interest, disclosure is made to an appropriate body or person, and there is no malice motivating the disclosure.

[ACCA Code of Ethics and Conduct, Section B1]

Conflicts of interest

A conflict of interest arises when the same audit firm is appointed for two companies that interact with each other, for example:

- Companies which compete in the same market.
- Companies which trade with each other.
- Companies in a legal dispute with each other.
- Providing services to a seller and a buyer in relation to the same transaction.

A conflict of interest may create a threat to the fundamental principles of objectivity and confidentiality.

It may be perceived that the auditor cannot provide objective services and advice to a company where it also audits a competitor.

Professional accountants should always act in the best interests of the client. However, where conflicts of interest exist, the firm's work should be arranged to **avoid the interests of one being adversely affected** by those of another and to prevent a breach of **confidentiality**.

In order to ensure this, the firm must **disclose** the nature of the conflict to the relevant parties and **obtain consent to act**.

The following additional safeguards should be implemented:

- Separate engagement teams (with different engagement partners and team members) who are provided with clear guidance on maintaining confidentiality.
- Review of the key judgements and conclusions by an independent person of appropriate seniority.

Measures which should be taken to reduce the threat of disclosure include:

- Procedures to limit access to client files
- Physical separation of confidential information including separate practice areas
- Signed confidentiality agreements by the engagement team members
- Specific training and communication.

If adequate safeguards cannot be implemented (i.e. where the acceptance/ continuance of an engagement would, despite safeguards, materially prejudice the interests of any clients), or if consent is refused, the firm must end or decline to perform professional services that would result in the conflict of interest.

[ACCA Code of Ethics and Conduct, Section 310]

Test your understanding 1

Murray case study: Ethical issues

You are an audit manager in Wimble & Co, a large audit firm which specialises in providing audit and accountancy services to manufacturing companies. Murray Co has asked your firm to accept appointment as external auditor. Murray Co manufactures sports equipment. Your firm also audits Barker Co, another manufacturer of sports equipment, and therefore your firm is confident it has the experience to carry out the audit.

You have been asked to take on the role of audit manager for Murray Co, should your firm accept the engagement. You own a small number of shares in Murray Co, as you used to be an employee of the company. Don Henman, who has been the engagement partner for Barker Co for twelve years, will take the role of engagement partner for Murray Co. The audit senior will be Tim Andrews, as his sister is the financial controller at Murray Co and therefore he knows the business well.

Your firm recently purchased some bibs, footballs and other equipment from Murray Co for the firm's annual football tournament. Murray Co has offered to provide this equipment free of charge to the firm if they accept the role as auditor.

Murray Co would also like your firm to provide taxation and accounting services. Specifically, the company would like you to prepare the financial statements and represent the company in a dispute with the taxation authorities.

The fees for last year's audit of Barker Co have not yet been paid, and you have been asked by Don Henman to look into the matter.

Required:

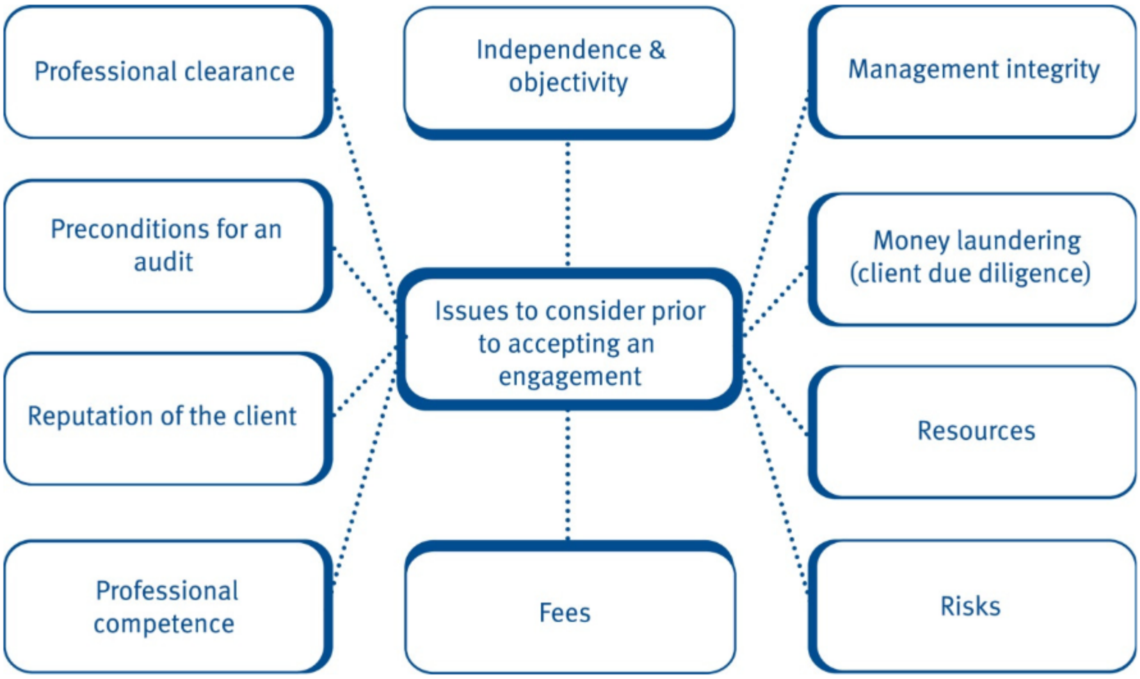
(a) **Describe the steps Wimble & Co should take to manage the conflict of interest arising from performing the audit of Murray Co and Barker Co. (4 marks)**

(b) **Explain SIX ethical threats which may affect the independence of Wimble & Co in respect of the audit of Murray Co or Barker Co, and for each threat identify ways in which the threat might be reduced.**

Prepare your answer using two columns headed Ethical threat and Possible safeguard respectively. **(12 marks)**

6 Accepting/continuing an audit engagement

An audit firm should only take on clients and work of an appropriate level of risk. For this reason, the firm will perform 'client screening'. The firm will consider the following matters before accepting a new engagement or client:



Professional clearance

If offered an audit role, the prospective audit firm must:

- Ask the client for permission to contact the existing auditor (and refuse the engagement if the client refuses).
- Contact the outgoing auditor, asking for all information relevant to the decision whether or not to accept appointment (e.g. overdue fees, disagreements with management, breaches of laws & regulations).
- If a reply is not received, the prospective auditor should try and contact the outgoing auditor by other means e.g. by telephone.
- If a reply is still not received, the prospective auditor may still choose to accept but must proceed with care.
- If a reply is received, consider the outgoing firm's response and assess if there are any ethical or professional reasons why they should not accept appointment.
- The existing auditor must ask the client for permission to respond to the prospective auditor.
- If the client refuses permission, the existing auditor should notify the prospective auditor of this fact.

Independence and objectivity

If the assurance provider is aware, prior to accepting an engagement, that the threats to objectivity cannot be managed to an acceptable level, the engagement should not be accepted.

Management integrity

A lack of integrity may indicate risks such as:

- Aggressive interpretation of accounting standards including window dressing of financial statements, management bias and inappropriate judgements.
- Weak control environment and possible override of controls.
- Intimidation of auditors.
- Criminal activities such as money laundering, fraud and breach of laws and regulations.
- Aggressive tax avoidance/evasion.
- Unreliable management representations.

Money laundering (client due diligence)

The firm must comply with money laundering regulations which require client due diligence to be carried out. If there is any suspicion of money laundering, or actual money laundering committed by the prospective client, the firm cannot accept the engagement.

Resources

The firm should consider whether there are adequate resources available at the time the engagement is likely to take place to perform the work properly. If there is insufficient time to conduct the work with the resources available the quality of the work could be affected.

Risks

Any risks identified with the prospective client (e.g. poor performance, poor controls, unusual transactions) should be considered. These risks can increase the level of engagement risk, i.e. the risk of issuing an inappropriate report.

Fees

The firm should consider the acceptability of the fee. The fee should be commensurate with the level of risk.

In addition, the creditworthiness of the prospective client should be considered as non-payment of fees can create a self-interest threat.

Professional competence

An engagement should only be accepted if the audit firm has the necessary skill and experience to perform the work competently.

Reputation of the client

The audit firm should consider the reputation of the client and whether its own reputation could be damaged by association.

If there are any reasons why the firm believes it may not be able to issue an appropriate report, the engagement should not be accepted.

Preconditions for an audit

ISA 210 *Agreeing the Terms of Audit Engagements* and the Code of Ethics and Conduct provides guidance to the professional accountant when accepting new work.

Before accepting (or continuing with) an engagement, the auditor must establish whether the preconditions for an audit are present and that there is a common understanding between the auditor and management and, where appropriate, those charged with governance. [ISA 210, 3]

The preconditions for an audit are that management acknowledges and understands its responsibility for:

- Preparation of the financial statements in accordance with the applicable financial reporting framework.
- Internal control necessary for the financial statements to give a true and fair view.
- Providing the auditor with access to all relevant information and explanations.

[ISA 210, 6b]

If the client imposes a limitation on the scope of the auditor's work to the extent that the auditor believes it likely that a disclaimer of opinion will ultimately be issued, then the auditor shall not accept the engagement, unless required to do so by law. [ISA 210, 7]

Continuance

Once the engagement is complete, the audit firm must revisit the acceptance considerations again to ensure it is appropriate to continue for the following year. If any significant issues have arisen during the year, such as disagreements with management or doubts over management integrity, the firm may consider resigning.

7 Engagement letters

Purpose

The engagement letter specifies the nature of the contract between the firm and client. The letter will be **sent before the audit commences**.

Its purpose is to:

- Minimise the risk of any misunderstanding between the practitioner and client
- Confirm acceptance of the engagement
- Set out the terms and conditions of the engagement.

Changes to the engagement letter

The engagement letter should be **reviewed every year** to ensure that it is up to date but does not need to be reissued every year unless there are changes to the terms of the engagement.

ISA 210 requires the auditor to consider whether there is a need to remind the entity of the existing terms of the audit engagement for recurring audits. Some firms choose to send a new letter every year to emphasise its importance to clients.

The auditor should issue a new engagement letter if the scope or context of the assignment changes after initial appointment, or if there is a need to remind the client of the existing terms.

Reasons for changes would include:

- Changes to statutory duties due to new legislation
- Changes to professional duties, for example, due to new or updated ISAs
- Recent changes in senior management
- A significant change in ownership.

[ISA 210, A30]

The contents of the engagement letter

The auditor will agree the terms of the audit engagement with management or those charged with governance, as appropriate.
[ISA 210, 9]

The terms are recorded in a written audit engagement letter and should include:

- The objective and scope of the audit of the financial statements
- The responsibilities of the auditor
- The responsibilities of management

- Identification of the applicable financial reporting framework for the preparation of the financial statements
- Reference to the expected form and content of any reports to be issued by the auditor.

[ISA 210, 10]

In addition, the following items will be included:

- Reference to professional standards, regulations and legislation applicable to the audit
- Limitations of an audit
- Expectation that management will provide written representations
- Basis on which the fees are calculated
- Agreement of management to notify the auditor of subsequent events after the auditor's report is signed
- Agreement of management to provide draft financial statements in time to allow the audit to be completed by the deadline
- Form (and timing) of any other communication during the audit.

[ISA 210, A24]

Other matters that the engagement letter may cover include:

- Arrangements concerning the involvement of internal auditors and other staff of the entity
- Limitations to the auditor’s liability
- Any obligations to provide audit working papers to other parties.

[ISA 210, A26]

The content of the engagement letter should be agreed with the client before any engagement related work commences.

The client's acknowledgement of the terms of the letter should be formally documented in the form of a director's signature.

e.g

Illustration 2 – Murray Co engagement letter

Wimble & Co
14 The Grove
Kingston
KI4 6AP

25 November 20X4

To the Board of Directors of Murray Co.

This letter and the attached terms of business dated 25 November 20X4 set out the basis on which we are to provide services as auditors and your and our respective responsibilities.

The objective and scope of the audit: You have requested that we audit the financial statements of Murray Co, which comprise the statement of financial position as at December 31, and the statement of profit or loss, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter. Our audit will be conducted with the objective of our expressing an opinion on the financial statements.

The responsibilities of the auditor: We will conduct our audit in accordance with International Standards on Auditing (ISAs). Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

Because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with ISAs.

In making our risk assessments, we consider internal control relevant to Murray Co's preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of Murray Co's internal control. However, we will communicate to you in writing concerning any significant deficiencies in internal control relevant to the audit of the financial statements that we have identified during the audit.

The responsibilities of management: Our audit will be conducted on the basis that management acknowledge and understand that they have responsibility:

(a) For the preparation and fair presentation of the financial statements in accordance with International Financial Reporting Standards.

(b) For such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

(c) To provide us with:

   (i) Access to all information of which management is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters.

   (ii) Additional information that we may request from management for the purpose of the audit.

   (iii) Unrestricted access to persons within the entity from whom we determine it necessary to obtain audit evidence.

As part of our audit process, we will request from management written confirmation concerning representations made to us in connection with the audit. We look forward to full cooperation from your staff during our audit.

Report: We will report to the members of Murray Co as a body, whether in our opinion the financial statements present fairly in all material respects, the financial position of Murray Co as at December 31, and its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards. The form and content of our report may need to be amended in the light of our audit findings.

Fees: Our fees, which will be billed as work progresses, are based on the time required by the individuals assigned to the engagement plus out-of-pocket expenses. Individual hourly rates vary according to the degree of responsibility involved and the experience and skill required.

Limitation of liability: To the fullest extent permitted by law, we will not be responsible for any losses, where you or others supply incorrect or incomplete information, or fail to supply any appropriate information or where you fail to act on our advice or respond promptly to communications from us.

Our work is not, unless there is a legal or regulatory requirement, to be made available to third parties without our written permission and we will accept no responsibility to third parties for any aspect of our professional services or work that is made available to them.

Confirmation of your agreement: Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our audit of the financial statements including our respective responsibilities.

If this letter and the attached terms of business are not in accordance with your understanding of our terms of appointment, please let us know.

Wimble & Co

Wimble & Co

Acknowledged and agreed on behalf of Murray Co by (signed)

....

Date

Further explanation of engagement letter contents

To the Board of Directors of Murray Co...

- Although the auditor's report is issued to the shareholders, the engagement letter is addressed to and signed by the directors of a company.

The responsibilities of the auditor... The responsibilities of management...

- It is important to set out the directors' and auditor's responsibilities for clarity and to reduce any expectation gap.
- The responsibilities of the auditor include the scope of the audit, i.e. the process by which the auditor will form their opinion. The same description of the scope of an audit is included in the auditor's report.

We will report to the members of Murray Co as a body...

- It is important to define who the intended users of the report are, i.e. who can place reliance on it.

Confirmation of your agreement...

- Both the client and the auditor must sign and retain a copy of the engagement letter for reference and to support the contract agreed.

Test your understanding 2

Explain each of the FIVE fundamental principles of ACCA's Code of Ethics and Conduct.

(5 marks)

Test your understanding 3

You are a manager in the audit department of Whilling and Abel. A potential new client, Truckers Co, a haulage company, has approached your firm to perform the external audit in addition to some other non-audit services for the year ending 30 September 20X5. Your audit firm was recommended to Truckers Co by an existing client, O&P, a shipping company who is also a major customer of Truckers Co.

You have been chosen to lead the engagement as you have experience of auditing haulage companies as you also manage the audit of O&P.

Whilst arranging the initial meeting with the directors of Truckers Co you discover that you studied accountancy with the finance director at university.

Truckers Co has not made a profit for the last two years. The directors explain that this is largely due to escalating costs in the industry including fuel price rises. They are confident they have now controlled their costs for the current year. They have also been approached to tender for a large profitable contract which would improve the company's financial performance going forward. They would like you to assist them with the preparation of this tender and present with them on the day.

The prior year financial statements are being audited by another audit firm. The finance director tells you that the current auditors have identified material misstatements but the board of directors are refusing to make these adjustments. If adjusted, it would turn the break-even position into a loss.

The current auditors have replied to your professional clearance letter and have informed you that they are still owed fees relating to the prior year.

You calculate that the potential fees from Truckers Co would amount to approximately 14% of your firm's total fee income.

Required:

(a) Identify and explain THREE threats to objectivity if Whilling and Abel accept Truckers Co as a new audit client. For each threat, recommend how the threat can be managed.

Prepare your answer using two columns headed Ethical threat and Possible safeguard respectively.

(6 marks)

(b) Explain the matters, other than ethical threats, that should be considered by Whilling and Abel prior to accepting the engagement. (4 marks)

(Total: 10 marks)

Test your understanding 4

You are holding a training course for your firm's new recruits covering the topic of ethics. The training will focus on the fundamental principles of ethical behaviour which accountants must follow. You have compiled the following quiz for the end of the session to test their understanding of the course content.

1 **Which of these is NOT a fundamental ethical principle?**

A Integrity

B Independence

C Objectivity

D Professional competence and due care

2 **Which of these statements provides the best explanation of integrity?**

A Members should act diligently and in accordance with applicable technical and professional standards

B Members should not bring the profession into disrepute

C Members should not use client information for personal advantage

D Members should be straightforward and honest in all professional and business relationships

3 **A member was found guilty of ethical misconduct by failing to respond to the professional clearance requests from another audit firm. This is a breach of which fundamental principle?**

A Integrity

B Independence

C Professional behaviour

D Professional competence and due care

4 **Which of the following statements best describes the conceptual framework approach to ethics?**

A A set of rules which must be followed in all circumstances

B A set of principles which the auditor applies based on professional judgement

C The conceptual framework is set out in company law

D A set of principles which the auditor applies at their discretion

5 **Why do auditors need to be independent?**

A To ensure users of the auditor's report can place reliance on it and have faith it is not biased

B To ensure the financial statements give a true and fair view

C To provide more regulation for auditors to increase the perception of quality

D The law requires it

Test your understanding 5

You are the audit manager responsible for the audit of Broome Co, a listed company. You have been informed by one of the audit juniors that the finance director has offered to take the audit team to a World Cup Final at the expense of the client as a thank you for an efficient audit.

The finance director has requested that you attend a social event where the company will outline a new rights issue of ordinary shares to shareholders. The finance director believes that the presence of the external auditor will add credibility to the rights issue and increase the chance of raising the required finance.

1 **Which of the following is NOT a threat to objectivity?**

A Independence

B Self-review

C Advocacy

D Intimidation

2 **Which ethical threat would be created if the audit manager attends the social event where the client will outline a new rights issue to shareholders?**

A Familiarity

B Advocacy

C Self-review

D Self-interest

3 **Which of the following is likely to be the most significant threat created by the offer of tickets to the World Cup Final?**

A Intimidation

B Advocacy

C Self-review

D Self-interest

4 **What is the restriction, if any, on the level of fee income that can be received from recurring work from Broome Co before a situation of dependency is presumed to exist?**

A 5%

B 10%

C 15%

D No restriction

5 **For clients where the level of fees must be monitored, what safeguard can the firm apply to reduce the threat to an acceptable level?**

(i) Rotation of audit team members on an annual basis.

(ii) Discussion of the matter with the audit committee.

(iii) Assign an engagement quality reviewer.

A (i) and (ii) only

B (i) and (iii) only

C (ii) and (iii) only

D (i), (ii) and (iii)

8 Chapter summary

Test your understanding answers

Test your understanding 1

(a) **Conflict of interest**

Wimble & Co must inform both clients of the conflict and obtain their consent to act.

Separate teams and engagement partners must be used for each audit.

Procedures should be in place to prevent access to information e.g. using teams from different offices.

The audit teams should sign confidentiality agreements.

An independent review partner should be assigned to ensure the safeguards have been effective.

(b) **Threats and safeguards**

Ethical threat	Possible safeguard
Financial interest The audit manager owns shares in Murray Co. This creates a **self-interest threat:** the audit manager may be reluctant to identify misstatements or modify the audit opinion for fear of damaging the value of their shareholding.	The audit manager must dispose of the shares immediately.
Previous employment with the client The audit manager used to work for Murray Co. This creates a **self-review threat**.	The audit manager should not be assigned to the audit of Murray Co if they would be auditing accounting records they had prepared whilst employed at the client.

If employment with the client was recent, the audit manager may be auditing work for which they were responsible when working for Murray Co. They may not identify errors in their own work, or if they are identified, they may not be brought to the client's attention. In addition, a familiarity threat may arise as the audit manager is likely to have friendships with previous colleagues which could result in the audit manager not applying sufficient professional scepticism and trusting the client too much.	
Gifts and hospitality Murray Co has offered free equipment to the auditor. Accepting gifts or hospitality from an audit client may create **self-interest** and familiarity threats. The auditor may feel indebted to the client or the offer may be seen to be a bribe from the client for a clean audit opinion.	The firm should evaluate the gift offered and unless trivial and inconsequential, the audit team must not accept the equipment. If the offer of free equipment is considered to be an inducement to accept the engagement, the offer should be declined, even if considered trivial and inconsequential.
Long association The engagement partner for Barker Co has been in place for twelve years. **Familiarity** and **self-interest** threats are created by using the same senior personnel on an assurance engagement for a long period of time. The audit partner may be too trusting of the client and may lack professional scepticism.	• Rotate the senior personnel. • Independent review of the senior personnel's work. • Independent quality review of the engagement.

Personal relationship The audit senior's sister is the financial controller at Murray Co and is therefore in a position to exert significant influence over the financial statements. Family and personal relationships between a member of an assurance team and a director of the client, or an employee of the client in a position to exert significant influence over the subject matter, may create **familiarity, self-interest or intimidation threats**. The audit senior may be too trusting of his sister and not apply sufficient professional scepticism.	Tim Andrews should not be on the audit team for Murray Co.
Representing the client Murray Co would like the audit firm to represent the company in a dispute with the taxation authorities. This would create **advocacy** and **self-review** threats as the audit firm would be seen to be taking sides with their client.	Firms must not represent audit clients in such disputes. The request should be politely declined.
Overdue fees The fee for last year's audit of Barker Co has not yet been paid. Overdue fees create a **self-interest threat** where they remain unpaid for some time. The auditor may be reluctant to raise issues with the client in case they refuse to pay. In addition, overdue fees could be perceived to be a loan. An audit firm must not enter into any loan arrangement with a client.	Obtain full or partial payment from the client. Do not perform any more work for the client until the outstanding fees have been paid. The auditor's report must not be issued until payment has been received.

Provision of other services Murray Co would like the audit firm to prepare the financial statements. Preparing the financial statements and then auditing them creates a significant self-review threat. If the auditor reviews work they were responsible for, they may not identify errors they have made.	• The firm must only perform work of a routine or mechanical nature. • Use staff who are not part of the audit team to prepare the financial statements. • Arrange an independent partner or senior staff member to review the work performed. **Tutorial note:** If an audit client is a listed or other public interest entity, the firm must not provide any accounting or bookkeeping services.

Test your understanding 2

Fundamental principles

Integrity. A professional accountant should be honest and straightforward in performing professional services.

Objectivity. A professional accountant should be fair and not allow personal bias, conflict of interest or influence of others to override objectivity.

Professional competence and due care. When performing professional services, a professional accountant should show competence and due care by acting diligently when performing their work and keeping up-to-date with developments in practice, legislation and techniques.

Confidentiality. A professional accountant should respect the confidentiality of information acquired during the course of providing professional services and should not use or disclose such information without obtaining client permission.

Professional behaviour. A professional accountant should act in a manner consistent with the good reputation of the profession and refrain from any conduct which might discredit the profession.

Test your understanding 3

(a) Threats and safeguards

Ethical threat	**Possible safeguard**
The audit manager knows one of the directors socially. This creates a familiarity threat. The auditor may be too trusting of the client or too sympathetic to the client's needs.	A different audit manager should be assigned to the audit of Truckers Co.
You are the audit manager of one of Trucker Co's major customers. This creates a conflict of interest where it may be difficult to act objectively for both clients. In addition, there is a risk that confidential information may be passed between the clients.	A different audit manager should be assigned to the audit of Truckers Co. Different teams should be used for the audit of Truckers Co and O&P and the audit team members should sign confidentiality agreements.
The audit manager has been asked to present at the tender for a contract. This would create an advocacy threat as the audit firm would be promoting the client.	The auditor should politely decline the invitation to present at the tender explaining their reasons.
The audit firm will provide non-audit services in addition to the external audit. This represents a self-review threat. The audit firm may ignore or overlook their own errors when auditing the financial statements.	The audit firm should ensure separate teams work on each engagement. An independent partner review of the files for each engagement should be arranged.
Total fees received from Trucker Co will represent 14% of the audit firm's total income. Fee dependence creates a self-interest threat. The firm may not wish to raise issues with the client for fear of losing them.	Whilling & Abel should to attempt to reduce dependency by increasing its client base. An independent review of the audit work should be arranged to ensure objectivity is not impaired. **Tutorial note:** If the client is a listed company, fee dependency is presumed when fees exceed 15% for two consecutive years.

(b) **Acceptance considerations**

Professional clearance

Truckers Co has not paid the current audit firm for the prior year audit. Whilling and Abel should consider whether it is advisable to accept the client as there could be a risk of irrecoverable debts in the future.

Disagreements with the current auditors

The directors are refusing to make adjustments proposed by the current auditors which is cause for concern as Whilling and Abel may encounter the same problems in future.

Integrity of management

The issues mentioned with regard to the current auditors suggest there may be a lack of management integrity. This increases the risk of difficulties with the audit which may mean the audit is too high a level of risk to accept.

Financial difficulties

Truckers Co has been loss-making for two years the most recent financial statements show a break-even position which would be adjusted to a loss if management agreed to make the adjustments proposed by the auditors. Truckers Co may be in financial difficulties which may mean the company ceases to trade.

Preconditions for an audit

The audit firm must only accept audits where management has confirmed the preconditions are in place, such as confirming responsibility for the preparation of the financial statements. If the preconditions are not present, the firm must not accept the engagement.

Money laundering client due diligence

The audit firm must comply with money laundering regulations and perform client due diligence. If the information gathered suggests a risk of money laundering, the firm must not proceed with the engagement.

Competence

The audit firm must ensure it is competent to perform the work otherwise audit risk will be too high.

Resources

The firm must assess whether it has sufficient resources available at the required time to perform the engagement.

Test your understanding 4

1	B	Whilst independence is an important characteristic for an auditor, it is not one of the fundamental principles.
2	D	Integrity means straightforward and honest.
3	C	Professional behaviour incorporates professional courtesy e.g. responding promptly to requests from other auditors.
4	B	The conceptual framework approach requires the auditor to assess each situation individually and act in a manner that would be seen as appropriate for a professional accountant. Principles rather than rules are used as principles can apply across national boundaries. The Code of ethics is professional guidance but not a legal requirement.
5	A	Independence means freedom from bias and influence.

Test your understanding 5

1	A	The threats to objectivity are self-interest, self-review, familiarity, advocacy and intimidation.
2	B	The audit manager may be seen to be promoting the company and encouraging the shareholders to subscribe to the rights issue.
3	D	Self-interest. The auditor may feel they owe the client something in return for such an expensive gift. The offer of gifts and hospitality may also create a threat to intimidation if the client uses the offer to attempt to influence the outcome of the audit. As the offer in this case is a thank you for performing an efficient audit, and there is no implication of undue pressure, the most significant threat arising is self-interest.
4	C	15%.
5	C	Independence matters should be discussed with the audit committee and an engagement quality review partner should be assigned. Rotation of the audit team would not provide a safeguard for this self-interest threat.

Chapter

5

Risk

Chapter learning objectives

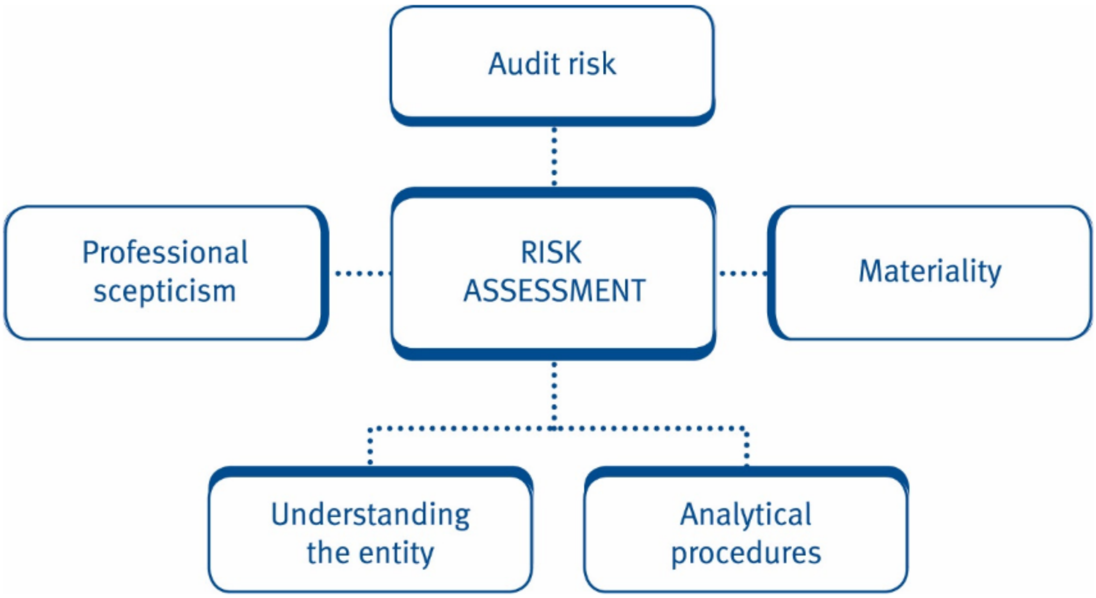
This chapter covers syllabus areas:

- B2b – Explain the need to plan and perform audit engagements with an attitude of professional scepticism and to exercise professional judgement
- B3 – Assessing audit risks
- B4 – Understanding the entity and its environment and the applicable financial reporting framework

Detailed syllabus objectives are provided in the introduction section of the text book.

PER

One of the PER performance objectives (PO18) is to is to prepare for and plan the audit process. You plan and control the engagement process, including the initial investigation. You also plan and monitor the audit programme – legally and ethically. Working through this chapter should help you understand how to demonstrate that objective.



1 Audit risk

One of the main requirements of the auditor is to:

'...obtain sufficient appropriate evidence to reduce audit risk to an acceptably low level...'

[ISA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with ISAs*, 17]

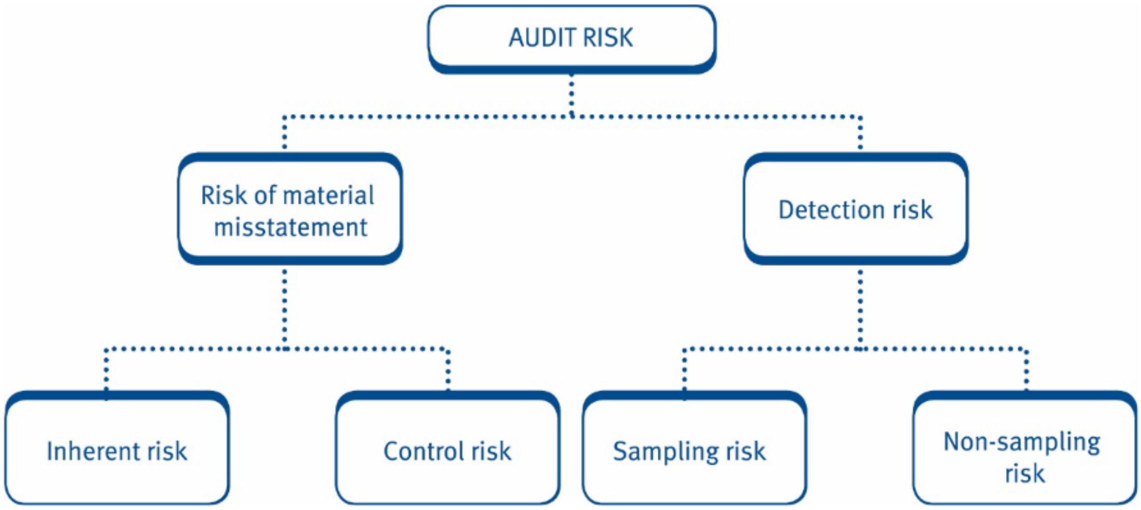
Audit risk is **the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated**. [ISA 200, 13c]

This means that they give an unmodified audit opinion when the financial statements are materially misstated.

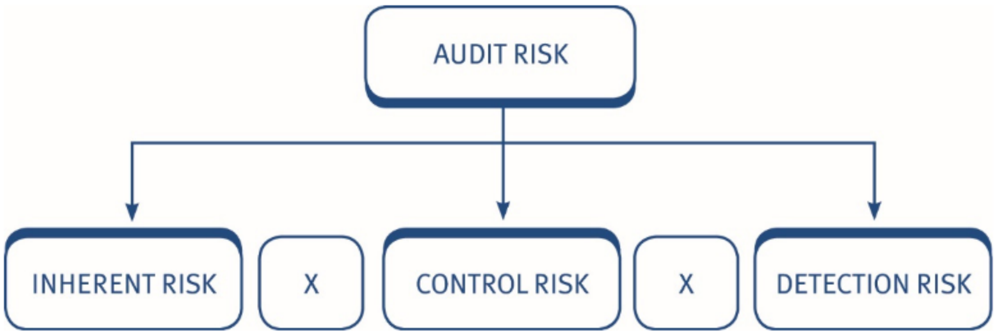
If this were to happen, the auditor could be sued by the intended users, disciplinary action could be taken by the relevant professional body and the firm could damage its reputation.

To avoid these potentially damaging consequences, the auditor will plan and perform the audit in such a way that audit risk is reduced to an acceptably low level.

Audit risk comprises the risk of material misstatement and detection risk.



Another way of showing this interaction is:



Tutorial note

The auditor can only influence detection risk, as inherent risk and control risk are influenced by the client. In order to reduce audit risk to an acceptable level, the auditor must reduce detection risk, for example, by assigning more experienced people to the audit team, performing a wider range of procedures and testing larger sample sizes.

Risk of material misstatement

Risk of material misstatement is **the risk that the financial statements are materially misstated prior to the audit**. [ISA 200, 13n]

This will be due to fraud or errors occurring during the year when transactions have been processed or when the financial statements have been prepared.

ISA 315 (Revised 2019) *Identifying and Assessing the Risks of Material Misstatement,* para 11 states:

'The objective of the auditor is to identify and assess the risk of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.'

What is a misstatement?

'A difference between the reported amount, classification, presentation, or disclosure of a financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.'

[ISA 450 *Evaluation of Misstatements Identified During The Audit*, 4a]

In conducting a thorough assessment of risk, auditors will be able to:

- Identify areas of the financial statements where misstatements are likely to occur early in the audit.
- Plan procedures that address the significant risk areas identified.
- Carry out an efficient, focused and effective audit.
- Reduce the risk of issuing an inappropriate audit opinion to an acceptable level.
- Minimise the risk of reputational and punitive damage.

Categories of misstatement

There are three categories of misstatements:

(i) Factual misstatements: a misstatement about which there is no doubt.

(ii) Judgemental misstatements: a difference in an accounting estimate that the auditor considers unreasonable, or the selection or application of accounting policies that the auditor considers inappropriate.

(iii) Projected misstatements: a projected misstatement is the auditor's best estimate of the total misstatement in a population through the projection of misstatements identified in a sample.

[ISA 450, A6]

The risk of material misstatement comprises inherent risk and control risk.

Inherent risk

Inherent risk is '**the susceptibility of an assertion about a class of transaction, account balance or disclosure to misstatement that could be material, before consideration of any related controls**'. [ISA 200, 13ni]

- Complex accounting treatment is an example of an inherent risk. For example, where an accounting standard provides guidance on a specific accounting treatment, this might not be understood by the client resulting in material misstatement.
- Inherent risk can arise due to the nature of the industry, entity or the nature of the balance itself. For example, inventory is inherently risky if it quickly becomes obsolete as it may not be valued appropriately at the lower of cost and net realisable value (NRV) as required by IAS®2 *Inventories*.

Inherent risk factors may be qualitative or quantitative. Qualitative inherent risk factors include:

- Complexity
- Subjectivity
- Change
- Uncertainty
- Susceptibility to misstatement due to management bias.

[ISA 315 (Revised 2019), A7]

Examples of inherent risks

Property, plant and equipment will be:

- overstated if expenditure on repairs is treated as asset expenditure.
- overstated if asset lives have been extended for depreciation purposes without any justification for the increase.
- overstated if assets ordered but not delivered by the reporting date are included in the financial statements.
- understated if asset expenditure has been incorrectly expensed.

Provision liabilities will be:

- overstated if there is no obligation created at the reporting date.
- overstated if it is not probable that payment will need to be made.
- understated if an inappropriate estimate of the provision is made.

Intangible assets will be:

- overstated if research costs have been capitalised rather than expensed.
- overstated if amortisation has not been charged on development projects which are now generating benefits for the company.
- overstated if an impairment charge has not been made for intangible assets which are impaired.
- understated if development costs have been expensed rather than capitalised.

Revenue will be overstated if it has been recognised before the performance obligations within the contract have been fulfilled.

Control risk

Control risk is '**the risk that a misstatement that could occur and that could be material, will not be prevented, or detected and corrected on a timely basis by the entity's controls**'. [ISA 200, 13nii]

The client should have controls in place, such as authorisation, segregation of duties, reconciliations, physical controls etc. to prevent and detect misstatements occurring when transactions are initiated, processed and recorded.

If effective controls are in place, the control system will either prevent the misstatements from occurring, or will detect misstatements that have occurred and the client can take action to correct them.

If controls are not effective, control risk will increase and there will be a greater risk of misstatements occurring in the financial statements.

Controls are covered in more detail in the chapter 'Systems and controls'.

Detection risk

Detection risk is '**the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material**'. [ISA 200, 13e]

Detection risk comprises **sampling risk** and **non-sampling risk**:

- **Sampling risk** is the risk that the auditor's conclusion based on a sample is different from the conclusion that would be reached if the whole population was tested, i.e. the sample was not representative of the population from which it was chosen. [ISA 530 *Audit Sampling*, 5c]
- **Non-sampling risk** is the risk that the auditor's conclusion is inappropriate for any other reason, e.g. the application of inappropriate procedures or the failure to recognise a misstatement. [ISA 530, 5d]

The auditor must amend the audit approach in response to risk assessment to ensure they detect the material misstatements in the financial statements.

This can be achieved by:

- Emphasising the need for professional scepticism.
- Assigning more experienced staff to complex or risky areas of the engagement.
- Changing the nature, timing and extent of direction and supervision of members of the engagement team and the review of work performed.
- Incorporating additional elements of unpredictability in the selection of further audit procedures.
- Changing the overall audit strategy, e.g.
  - The auditor’s determination of performance materiality.
  - The auditor’s plans to test the operating effectiveness of controls.
  - The nature, timing and extent of substantive procedures.

[ISA 330 *The Auditor's Response to Assessed Risks*, A1]

Professional scepticism

Professional scepticism is: **'An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to fraud or error, and a critical assessment of audit evidence**.' [ISA 200, 13l]

This requires the audit team to have a good knowledge of how the client’s activities are likely to affect its financial statements. The audit team should discuss these matters in a planning meeting before deciding on the detailed approach and audit work to be used.

Professional scepticism is necessary for the critical assessment of audit evidence gathered when performing the risk assessment procedures, and assists the auditor in remaining alert to audit evidence that is not biased towards corroborating the existence of risks or that may be contradictory to the existence of risks.

Professional scepticism is an attitude that is applied by the auditor when making professional judgements that then provides the basis for the auditor’s actions. The auditor applies professional judgement in determining when the auditor has audit evidence that provides an appropriate basis for risk assessment.
[ISA 315 (Revised 2019), A12]

How to apply professional scepticism

Professional scepticism requires the auditor to **be alert to**:

- Audit **evidence that contradicts other** audit **evidence**.
- Information that brings into question **the reliability of documents and responses to enquiries** to be used as audit evidence.
- Conditions that may indicate **possible fraud**.
- Circumstances that suggest **the need for audit procedures in addition to those required by ISAs**.

[ISA 200, A20]

Exercising professional scepticism

Example 1

A customer of a client is having financial difficulties and has not paid any invoices for 6 months when the client's credit terms are 10 days. The auditor has asked the FD about the outstanding debt and whether it should be written off. The FD has informed the auditor that they believe the debt will be paid as they have never experienced irrecoverable debts with this customer in the past, as a result, no expense has been recognised.

To exercise professional scepticism, the auditor should seek alternative, corroborative evidence to support the FD's claim as they may not want to make allowance for the debt as this will reduce profit. The auditor could review bank statements post year end to identify if payment has been made or could review any correspondence between the customer and the client indicating when payment might be made. These procedures provide more reliable evidence than an enquiry with management who may tell the auditor what they think the auditor wants to hear to avoid an adjustment to the financial statements. Obtaining a written representation from management is only marginally more reliable than an enquiry. Client generated evidence is always the least reliable form of evidence and the auditor should always look for better quality evidence where possible due to the risk of management bias.

Example 2

An audit client is being sued by an ex-employee for unfair dismissal. The FD tells the auditor that the company's lawyer believes it is probable that the employee's claim will not succeed, as a result, no provision has been recognised.

To exercise professional scepticism, the auditor should review correspondence received from the lawyer confirming this position. More reliable evidence would be obtained if the auditor obtained a direct, external confirmation from the lawyer confirming the position as this evidence would not have been obtained via the client.

2 Materiality

What is materiality?

'Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.'
[ISA 320 *Materiality in Planning and Performing an Audit*, 2]

International Accounting Standards Board definition of materiality

The following definition of materiality is given in IAS 1 *Presentation of Financial Statements*, effective from 1 January 2020:

'Information is material if omitting, misstating or obscuring it could reasonably be expected to influence the decisions that the primary users of general-purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity.'

What is the significance of materiality?

If the financial statements contain material misstatement they cannot be deemed to show a true and fair view.

As a result, the focus of an audit is identifying the significant risks of material misstatement in the financial statements and then designing procedures aimed at identifying and quantifying them.

How is materiality determined?

The determination of materiality is a **matter of professional judgement**. The auditor must consider:

- Whether the misstatement would affect the economic decision of the users
- Both the size and nature of misstatements
- The information needs of the users as a group.

Materiality is a subjective matter and should be considered in light of the client's circumstances.

Material by size

ISA 320 recognises the need to establish a financial threshold to guide audit planning and procedures. The following benchmarks may be used as a starting point:

- ½ – 1% revenue
- 5 – 10% profit before tax
- 1 – 2% total assets.

The above are common benchmarks but different audit firms may use different benchmarks or different thresholds for each client.

Tutorial note

In the exam, use the lowest end of the range for assessing whether a misstatement is material. If the misstatement is greater than ½% revenue/ 5% of profit before tax/1% total assets, assume it is material.

Material by nature

Materiality is not only looked at from a financial perspective. Some items may be material by nature. Examples include:

- Misstatements that affect compliance with regulatory requirements.
- Misstatements that affect compliance with debt covenants.
- Misstatements that, when adjusted, would turn a reported profit into a loss for the year.
- Misstatements that, when adjusted, would turn a reported net-asset position into a net-liability position.
- Transactions with directors, e.g. salary and benefits, personal use of assets, etc.
- Disclosures in the financial statements relating to possible future legal claims or going concern issues, for example, could influence users' decisions and may be purely narrative. In this case a numerical calculation is not relevant.

Illustration 1 – Murray Co materiality

Financial statement extracts	20X4	20X3
	$000	$000
Revenue	21,960	19,580
Total assets	9,697	7,288
Profit before tax	1,048	248

Materiality	Lower	Upper
Revenue	**½%**	**1%**
	110	220
Profit before tax	**5%**	**10%**
	52	105
Total assets	**1%**	**2%**
	97	194

Materiality is not normally based on revenue, except in circumstances when it would not be meaningful to base materiality on profit, e.g. because the entity being audited is a not-for-profit entity or where there is a small profit (or a loss) as this will result in over-auditing of the financial statements (as was the case for Murray Co in the prior year).

More than $105,000 profit is material to the statement of profit or loss, therefore preliminary materiality is likely to be set lower than this amount. Less than $52,000 is not material to profit (or to the statement of financial position) so preliminary materiality should not be less than this amount.

A suitable preliminary materiality level is most likely to be one that lies within the overlap of the ranges calculated for profit and total assets. $97,000 (1% of total assets) represents 9% profit. As this is at the lower end of the assets range, this would be a relatively prudent measure of materiality (resulting in a higher level of audit work).

$105,000 (10% of profit) represents 1.1% of total assets. Preliminary materiality could be set at this end of the range if this was a recurring audit. However, as this is the first year auditing this client, preliminary materiality is likely to be lower.

The financial statements are draft and therefore more errors may be expected than if they were actual figures. Consequently, sample sizes for audit testing should be increased (i.e. preliminary materiality should be set at a relatively lower level).

Taking all of these factors into consideration, a suitable range for **preliminary materiality** is **$97,000 – $105,000**.

Performance materiality

It is unlikely, in practice, that auditors will be able to design tests that identify individual material misstatements. It is much more common that misstatements are material in aggregate (i.e. several misstatements added together).

For this reason, ISA 320 introduces the concept of **performance materiality**.

Performance materiality is **'The amount set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole**.' [ISA 320, 9]

- The auditor sets **performance materiality** at a value **lower than overall materiality**, and uses this lower threshold when designing and performing audit procedures.
- This **reduces** the **risk** that the auditor will fail to identify misstatements that are material when added together.

3 Risk assessment procedures

The auditor should perform the following risk assessment procedures:

- **Enquiries** with management, of appropriate individuals within the internal audit function (if there is one), and others (with relevant information) within the client entity (e.g. about external and internal changes the company has experienced)
- **Analytical procedures**
- **Observation** (e.g. of control procedures)
- **Inspection** (e.g. of key strategic documents and procedural manuals).

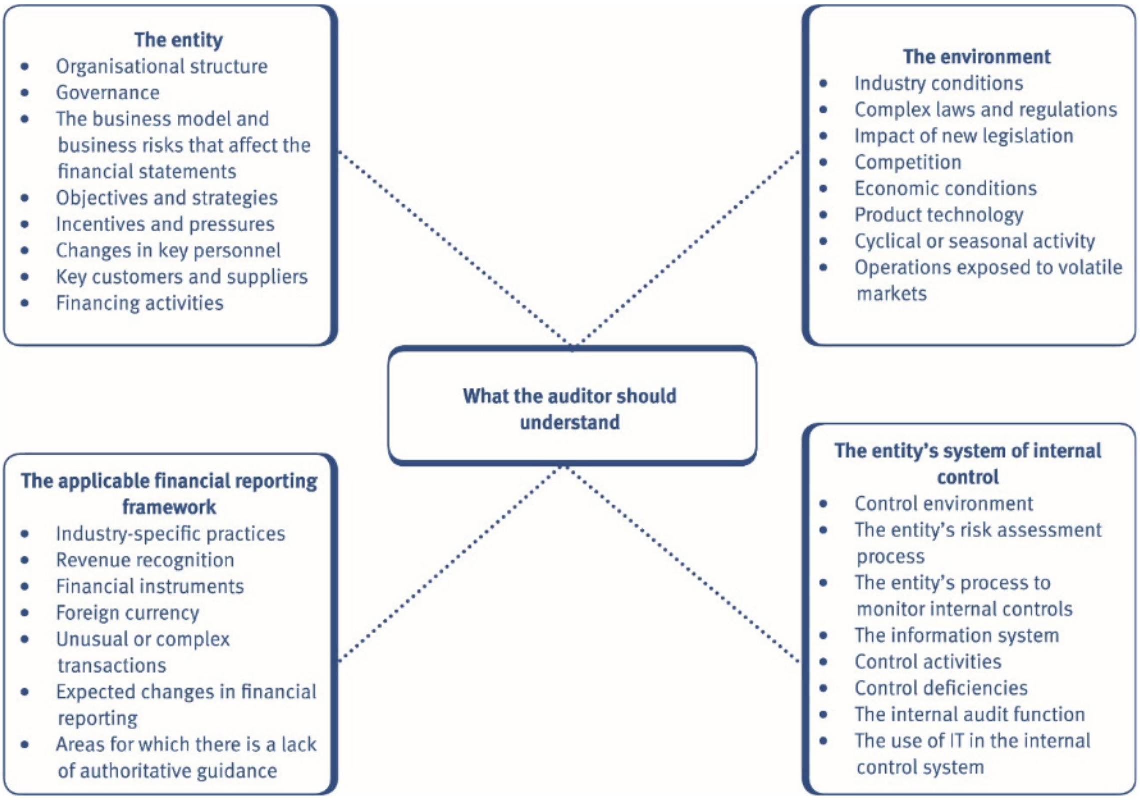
[ISA 315 (Revised 2019), 14]

Understanding the entity, its environment, the applicable financial reporting framework and its system of internal control

The auditor is required to obtain an understanding of:

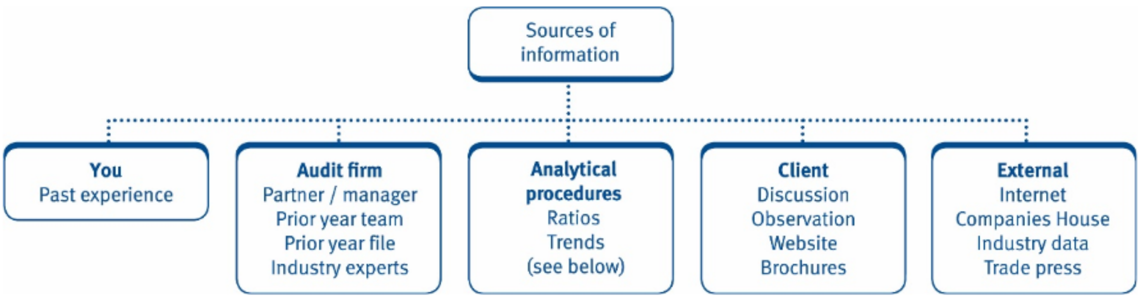
- Aspects of the entity and its environment:
  - The complexity of the entity's organisational structure. A more complex structure increases the risk of material misstatement.
  - Ownership and governance. This includes consideration of the level of distinction between the owners, management and those charged with governance.
  - The business model including the extent to which the business model integrates the use of IT. This includes consideration of whether the entity has multiple legacy IT systems which are not well integrated and therefore increase the risk of material misstatement, and whether the IT systems are outsourced to a third-party service provider.
  - Industry, regulatory and other external factors.
  - The measures used, internally and externally, to assess the entity's financial performance.
- The applicable financial reporting framework, and whether the entity's accounting policies are appropriate and consistent with the applicable financial reporting framework.
- The components of the entity's system of internal control and control deficiencies. (Covered in more detail in the chapter 'Systems and controls')

[ISA 315 (Revised 2019), 19, 20, A56]



The auditor will use this understanding to assess the identified risks of material misstatement (inherent and control risks) at the financial statement level and the assertion levels to design further audit procedures in response to these risks. [ISA 315 (Revised 2019), 13]

The information used to obtain this understanding can come from a wide range of sources:



Analytical procedures

'Evaluations of financial information through analysis of plausible relationships among both financial and non-financial data and investigation of identified fluctuations, inconsistent relationships or amounts that differ from expected values by a significant amount.'
[ISA 520 *Analytical Procedures*, 4]

Analytical procedures are fundamental to the auditing process.

The auditor is **required to perform analytical procedures as risk assessment procedures in accordance with ISA 315 (Revised 2019)** in order to:

- Help identify inconsistencies, **unusual transactions or events, and amounts, ratios, and trends** that might have audit implications. [A27]
- Help identify **risks of material misstatement due to fraud**. [A27]
- Identify and assess aspects of the entity of which the auditor was unaware. [A28]

Analytical procedures include **comparisons** of the entity's financial information with, for example:

- Comparable information for **prior periods**.
- **Anticipated results** of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.
- Similar **industry information,** such as a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.

[ISA 520, A1]

When performing analytical procedures, the auditor will also consider **relationships**, for example between:

- Related figures such as revenue and receivables, purchases and payables; and
- Financial and non-financial information such as payroll costs and number of employees.

[ISA 520, A2]

Data analytics may be used to perform analytical procedures for example using software to extract data from the client's information system to perform a comparison of actual recorded amounts to budgeted amounts.
[ISA 315 (Revised 2019), A31]

Analytical procedures during the audit

Analytical procedures can be used at all stages of an audit.

Preliminary analytical procedures

ISA 315 (Revised 2019) requires the auditor to perform analytical procedures as a risk assessment procedure in order to help the auditor to obtain an understanding of the entity and assess the risk of material misstatement.

Substantive analytical procedures

ISA 500 *Audit Evidence* allows the auditor to use analytical procedures as a substantive procedure to help detect misstatement.

Final analytical procedures

In addition, ISA 520 *Analytical Procedures* requires the auditor to use analytical procedures at the completion stage of the audit when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

Automated tools and techniques, including audit software and data analytic tools, are increasingly being used to perform this analysis. This is covered in more detail in the chapter 'Evidence'.

Key ratios

Profitability ratios

Gross profit margin: gross profit/sales revenue × 100%

Operating profit margin: operating profit/sales revenue × 100%

Auditors would expect the relationships between costs and revenues to stay relatively stable. Things that can affect these ratios include: changes in sales prices, bulk purchase discounts, economies of scale, new marketing initiatives, changing energy costs, wage inflation.

Therefore, any unusual fluctuation in the profitability ratios could mean the figures are materially misstated. For example, if the gross profit margin improves, this could be caused by any or all of the following:

- Overstated revenue because of inappropriate revenue recognition or cut-off issues.
- Understated cost of sales because of incomplete recording of purchases.
- Understated cost of sales because of overvaluation of closing inventory.

Efficiency ratios

These ratios show how efficient the business is at converting assets into cash or how long it takes to pay suppliers.

Receivables collection period: receivables/revenue × 365

Payables payment period: payables/purchases × 365

Inventory holding period: inventory/cost of sales × 365

Asset turnover: revenue/total assets

Any changes can indicate significant issues, such as:

- Overvaluation of receivables if sufficient allowance for credit losses is not made.
- Overvaluation of inventory if damaged or obsolete inventory has not been written down.
- Inadequate disclosure of going concern issues if the company has poor cash flow and is unable to pay its suppliers.

Liquidity ratios

Current ratio: current assets/current liabilities

Quick ratio: (current assets – inventory)/current liabilities

These ratios indicate the ability of a company to meet its short-term debts. As a result, these are key indicators when assessing going concern. If there are indicators of going concern uncertainties, the financial statements must include disclosure and the auditor must evaluate the adequacy of the disclosures.

Investor ratios

Gearing: borrowings/(share capital + reserves)

Return on capital employed (ROCE): profit before interest and tax/(share capital + reserves + borrowings)

Gearing is a measure of external debt finance to internal equity finance. ROCE indicates the returns those investments generate.

Any change in gearing or ROCE could indicate a change in the financing structure of the business or it could indicate changes in overall performance of the business. These ratios are important for identifying potentially material changes to the statement of financial position (new/repaid loans or share issues) and for obtaining an overall picture of the annual performance of the business.

Data analytics at the planning stage

It is 1 July 20X5. The audit planning of Beau Boutique, for the year ending 31 July 20X5 is currently being performed and the final audit is due to take place in October 20X5. Beau Boutique is a fashion retailer.

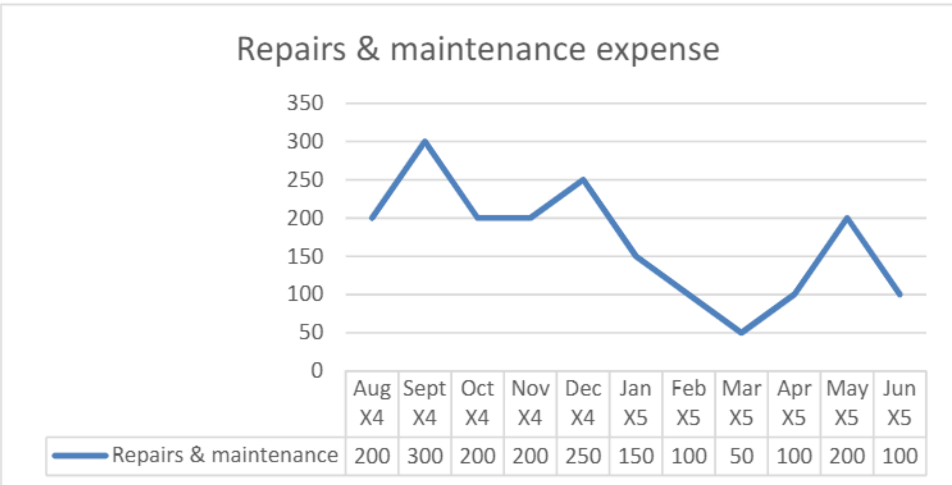
Property, plant and equipment

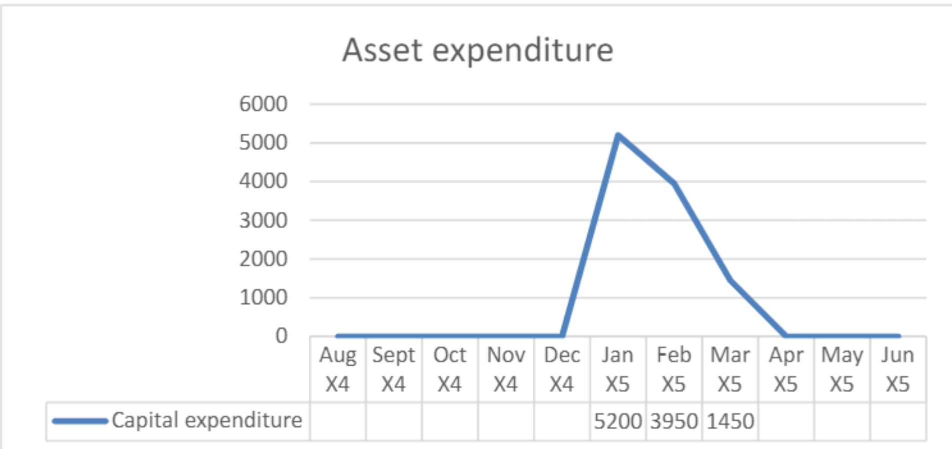
During your planning meeting with the client you are informed that the company has undertaken a $10,000 upgrade to its property, plant and equipment.

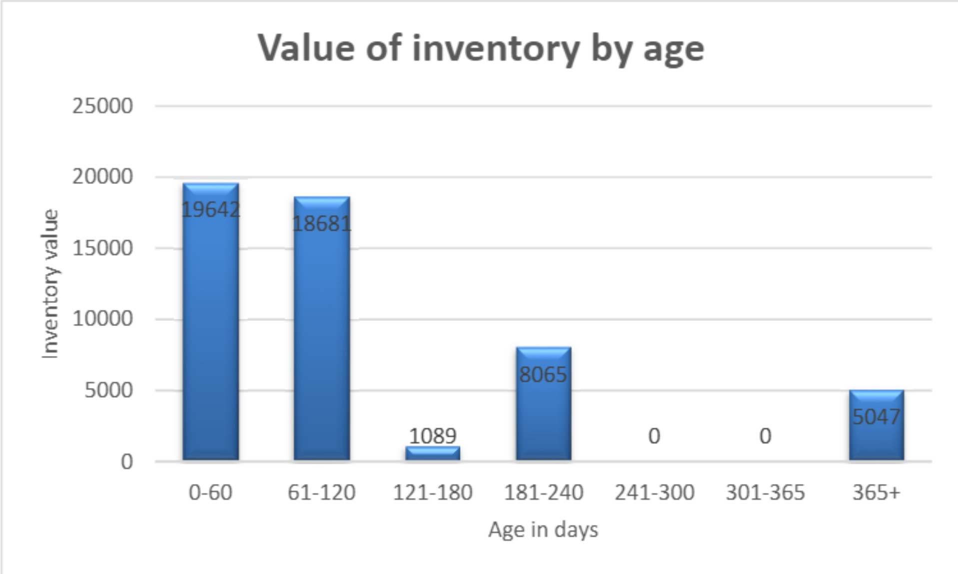
Inventory

Inventory for the Spring/Summer 20X5 season was purchased in September 20X4 with deliveries between November 20X4 and June 20X5. The company will discount any unsold inventory from the Spring/Summer range in September 20X5. Inventory for the Autumn/Winter 20X5 season was purchased in March 20X5 with deliveries arriving from May 20X5.

The following visual information has been produced by the auditor's data analytics software:







Example 1 – Property, plant and equipment

The increase in asset expenditure coincides with a decrease in repairs and maintenance expenditure between January 20X5 and March 20X5. This may indicate an audit risk that repairs and maintenance expenditure has been incorrectly capitalised, especially as the upgrade has cost $10,600 instead of $10,000. Repairs and maintenance expenditure for these three months is lower than usual, which further indicates misclassification.

Example 2 – Inventory

0 – 180 days

This inventory relates to the Spring/Summer 20X5 and Autumn/Winter 20X5 ranges. Valuation is unlikely to be an issue as sales will still be occurring for the Spring/Summer 20X5 inventory.

181 – 240 days

This inventory is still likely to be sold at the usual selling price until September 20X5 when it will be discounted. The auditor should include audit procedures in the audit plan to focus on the valuation of this inventory at the final audit stage in October 20X5 as any unsold inventory will have been discounted and if the NRV is lower than cost, the remaining inventory should be written down.

If it is unlikely that the inventory will be sold, even at discounted prices, the inventory should be written off. As inventory within this age category represents 15% of the total inventory value, this could be a material audit risk.

241 + days

Inventory older than 240 days is unlikely to be sold and should be written off. This represents 10% of the inventory value and may be a significant audit risk. The auditor should bring this issue to the attention of the client to ensure appropriate valuation is made when the financial statements are prepared.

4 Exam focus – Audit risk questions

Audit risk identification and explanation

Audit risk is regularly examined and it is important to answer the question from an auditor's perspective rather than the perspective of the client.

The auditor is trying to detect material misstatements in the financial statements to avoid issuing the wrong opinion. The auditor is not looking to identify risks which affect the profitability of the client, they are not business consultants.

Tutorial note

A common mistake that candidates make in exams is to explain business risks rather than audit risks. **Marks will only be awarded for audit risks** as business risks are not examinable in this syllabus. Therefore, take care to ensure your answer is relevant to the requirement.

For example:

Identification of risk from the scenario	Audit risk explanation	NOT Audit risk (business risk)
Customers are struggling to pay debts.	Receivables may be overstated if irrecoverable debts are not written off.	Irrecoverable debts may arise reducing the profit of the company.
The client operates in a fast-paced industry.	Inventory may be overstated if the inventory is obsolete and net realisable value is lower than cost.	Inventory may have to be written off reducing the profit of the company.
Revenue is falling due to recession. The cash flow forecast shows negative cash flows for the next 12 months.	If other factors are present, this could mean the company is unable to continue to trade for the foreseeable future and going concern disclosures may be required. There is a risk that adequate disclosure is not made.	Falling revenue will result in reduced profit and possible going concern issues.

In the exam, make sure you explain the risk by stating the area of the financial statements which is at risk of material misstatement. A risk of material misstatement will affect either a balance in the financial statements, a disclosure in the notes to the financial statements or the basis of preparation.

To explain the audit risk properly:

- State the financial statement assertion affected, e.g. cut-off, valuation, completeness, etc.
- State the specific area of the financial statements affected. For example, where a receivable balance is overvalued and potentially irrecoverable, an appropriate explanation would be ‘trade receivables are overstated’ or ‘the allowance for receivables is understated’. No marks will be awarded for stating ‘assets are overstated’ or ‘profit is overstated’.
- State the risk to the balance e.g. overstated or understated. Misstated is only awarded if it is clear that the balance could be either over or understated.
- State the component of audit risk affected, e.g. inherent, control or detection risk.

Auditor responses to risks

Once the risks are identified, you must suggest a **relevant** audit response to the risk identified.

The response must specifically deal with the risk. You should not suggest audit responses that address the balance generally.

<table>
<tr><th>Audit risk</th><th>Relevant response</th><th>Irrelevant response</th><th>Explanation</th></tr>
<tr><td rowspan="3">Customers are struggling to pay debts.

Receivables may be overstated if irrecoverable debts are not written off.</td><td rowspan="3">Inspect after date cash receipts from customers to see if paid post year end proving the debt is appropriately valued.

Review the aged receivables listing for old debts which may not be recoverable and discuss the need for an allowance to be made with management.</td><td>Obtain the receivables listing and cast it to verify arithmetical accuracy.</td><td>The risk identified is overvaluation. Obtaining the listing does not provide evidence that the debts are appropriately valued.</td></tr>
<tr><td>Obtain external confirmation from customers to confirm existence.</td><td>External confirmation is providing evidence of existence but not valuation.</td></tr>
<tr><td>The company should improve its credit control procedures.</td><td>This is a client response not an auditor response.</td></tr>
</table>

The client operates in a fast-paced industry. Inventory may be overstated if obsolete items are not written off.	Obtain the aged inventory listing and review for old items. Discuss with management the need for these to be written down in the financial statements.	The company should discount the inventory in order to sell it.	This is a client response not an auditor response.
		Attend the inventory count to confirm existence of the inventory.	As written, the response of attending the inventory count is confirming existence, not valuation. This should be reworded to say attend the inventory count and look out for old or obsolete items that should be written down in the financial statements.
Revenue is falling due to recession. The cash flow forecast shows negative cash flows for the next 12 months. Going concern disclosures may not be adequate if the company has trading difficulties.	Assess the client's ability to continue as a going concern by examining the forecasts prepared by management and assess the reasonableness of the assumptions used in the forecasts.	Perform an analysis of past performance and assess the profitability of the company. Calculate liquidity ratios.	Analysing past performance does not provide sufficient appropriate evidence as to future performance. Profit can be distorted by accounting policies and does not mean the company has adequate cash flow to pay its suppliers and employees. Calculation of ratios can help identify indicators of going concern problems but further procedures would need to be performed to obtain evidence of the company's ability to continue to trade.

Test your understanding 1

Murray case study: Audit risks

Your firm Wimble & Co has recently accepted appointment as auditor of Murray Co (a manufacturer of sports equipment).

Having sold your shares in Murray Co, you have been assigned as audit manager and you have started planning the audit (although you were an employee of Murray Co, this was many years ago and you did not have any involvement in the preparation of the financial statements). You have held a meeting with the client and have ascertained the following:

Murray Co manufactures sports equipment. Most items of equipment, such as tennis rackets, hockey sticks and goals, take less than one day to manufacture. Murray Co's largest revenue generating product, ergometers (rowing machines), takes up to one week to manufacture. Murray Co refurbished the assembly line for the ergometers during the year. Murray Co uses a third-party warehouse provider to store the manufactured ergometers and approximately one quarter of the other equipment.

Historically, Murray Co has only sold to retailers. For the first time this year, Murray Co has made sales directly to consumers, via a new website. The website is directly linked to the finance system, recording sales automatically. Website customers pay on ordering. The website development costs have been capitalised. This initiative was implemented to respond to market demands, as retailer sales have fallen dramatically in the last two years. Some of Murray Co's retail customers are struggling to pay their outstanding balances. Several of the sales team were made redundant last month as a result of the falling retailer sales.

Murray Co is planning to list on the stock exchange next year.

Required:

Using the information provided, describe SIX audit risks and explain the auditor's response to each risk in planning the audit of Murray Co.

Note: Prepare your answer using two columns headed Audit risk and Auditor’s response respectively.

(12 marks)

Test your understanding 2

Murray case study: Analytical procedures

Draft Statement of financial position as at 31 December 20X4

	20X4	20X3
	$000	$000
Non-current assets		
Property plant and equipment	5,350	4,900
Website development	150	0
	5,500	4,900
Current assets		
Inventory	2,109	1,300
Trade receivables	2,040	1,050
Cash and cash equivalents	48	38
	4,197	2,388
	9,697	7,288
Equity		
Share capital (50c shares)	2,100	2,100
Retained earnings	2,959	2,156
	5,059	4,256
Non-current liabilities		
Long term loan	2,800	1,500
Current liabilities		
Provisions	240	195
Trade and other payables	1,400	1,205
Accruals	18	12
Bank overdraft	180	120
	1,838	1,532
	9,697	7,288

Draft Statement of profit or loss for the year ended 31 December 20X4

	20X4	20X3
	$000	$000
Revenue	21,960	19,580
Cost of sales	(18,560)	(17,080)
Gross profit	3,400	2,500
Operating expenses	(2,012)	(2,012)
Operating profit	1,388	488
Finance cost	(340)	(240)
Profit before tax	1,048	248
Taxation	(245)	(24)
Profit for the period	803	224

Required:

Using the financial information provided, and the information from TYU 1, perform analytical procedures on the draft financial statements of Murray Co describe the audit risks that should be considered when planning the audit of Murray Co.

(10 marks)

Test your understanding 3

It is 1 July 20X5. You are an audit senior at JPR Edwards & Co and you are currently planning the audit of Hook Co for the year ending 30 September 20X5. Your firm was recently appointed as auditor after a successful tender to provide audit and tax services. JPR Edward & Co were asked to tender after the lead partner, Neisha Selvaratalm, met Hook Co's CEO, Taylor Tucker, at a charity cricket match. Hook Co was unhappy with the previous auditors as it was felt the audit did not add much value to the company.

Hook Co manufactures electrical goods such as MP3 players, smartphones and personal computers for larger companies with established brands. Its key client, which represents 70% of its revenue, was the market leader in smartphones and MP3 players last year with 60% market share.

Hook Co uses a number of suppliers to source components for its products. Most suppliers are based in the UK, however microchips are imported from a number of overseas suppliers. Hook Co's products are assembled and packaged in one factory in the UK before being distributed to customers across the UK. The work-in-progress balance is expected to be material at the year end.

During the year, Hook Co started developing smartphone applications. $1 million has been spent on an application called 'snore-o-meter' which allows users to record the sounds they make while they are asleep. There was a technical difficulty in production which meant the launch of 'snore-o-meter' has been delayed from June to October 20X5.

To fund the expansion into smartphone applications, Hook Co is seeking a listing on the London Stock Exchange in the fourth quarter of the year.

Required:

Using the information provided, describe FIVE audit risks and explain the auditor's response to each risk in planning the audit of Hook Co.

Note: Prepare your answer using two columns headed Audit risk and Auditor's response respectively.

(10 marks)

Test your understanding 4

Define materiality and explain how the level of materiality is assessed.

(5 marks)

Test your understanding 5

You have received the latest management accounts from your client, Esperence Co, to help with your risk assessment for the forthcoming audit. The management accounts show actual results for the year to date, January to October inclusive. In October, Esperence Co received a claim from a customer as a result of a defective product.

1 **Which of the following is an example of an audit risk for Esperence Co?**

A The client is being sued by a customer for a defective product and if the claim is successful, the compensation awarded is likely to be significant

B The client is being sued by a customer for a defective product. The publicity of the case could damage the company's reputation

C The client will have to spend a significant amount of money on improving its quality control procedures to avoid the same defects occurring again

D Provisions may be understated if the probable payment resulting from the court case is not recognised as a liability in the financial statements

2 **Which of the following is the correct formula for calculating the payables payment period using the management accounts of Esperence Co?**

A Payables/Cost of sales × 304

B Payables/Cost of sales × 365

C Payables/Revenue × 304

D Payables/Revenue × 365

3 **Which of the following is NOT an analytical procedure?**

A Calculation of gross profit margin and comparison with prior year

B Recalculation of a depreciation charge

C Comparison of revenue month by month

D Comparison of expenditure for current year with prior year

4 **Which of the following is NOT a ratio?**

A Gross profit margin

B Acid test

C Inventory turnover

D Revenue growth

5 **You have used the management accounts to calculate the gross profit margin and found it to be higher than the prior year figure. Which of the following would provide a possible explanation?**

A Sales prices have been reduced to increase sales volumes

B Prices charged by suppliers have increased but the company has not increased sales prices to customers to cover the increased costs

C Closing inventory has been overvalued

D Administration expenses have decreased

Test your understanding 6

You are the audit manager responsible for planning the audit of Fremantle Co. The draft financial statements show profit before tax of $3m and total assets of $50m. You have held a planning meeting with the client and have performed preliminary analytical procedures on the draft financial statements. You are currently assessing preliminary materiality for the audit and performing further risk assessment procedures.

1 **Which of the following statements is FALSE in relation to materiality?**

A Materiality can be assessed by size or nature

B A balance which is omitted from the financial statements cannot be material

C Materiality is a matter of professional judgement for the auditor

D There is an inverse relationship between risk and materiality. If audit risk is high, the materiality level set by the audit will be lower

2 **Which of the following procedures is NOT required to be performed in accordance with ISA 315 (Revised 2019) *Identifying and Assessing the Risks of Material Misstatement*?**

A Inspection

B Observation

C External confirmation

D Enquiry

3 **Based on the above draft figures, what would be an appropriate level at which to set preliminary materiality?**

A $150,000 for the statement of profit and loss and $500,000 for the statement of financial position

B $500,000 for the statement of profit and loss and $150,000 for the statement of financial position

C $1,500 for the statement of profit and loss and $50,000 for the statement of financial position

D $50,000 for the statement of profit and loss and $1,500 for the statement of financial position

4 **Performance materiality should be used by the auditor when performing substantive testing during the audit. Which of the following best describes performance materiality?**

A The maximum amount of misstatement the auditor is willing to accept

B The amount at which the auditor deems the misstatement to be trivial

C An amount which could influence the economic decisions of the users taken on the basis of the financial statements

D An amount set below materiality for the financial statements as a whole to reduce, to an acceptably low level, the risk that misstatements could be material in aggregate

5 **Professional scepticism must be applied by the auditor during the audit. Which of the following is NOT an application of professional scepticism?**

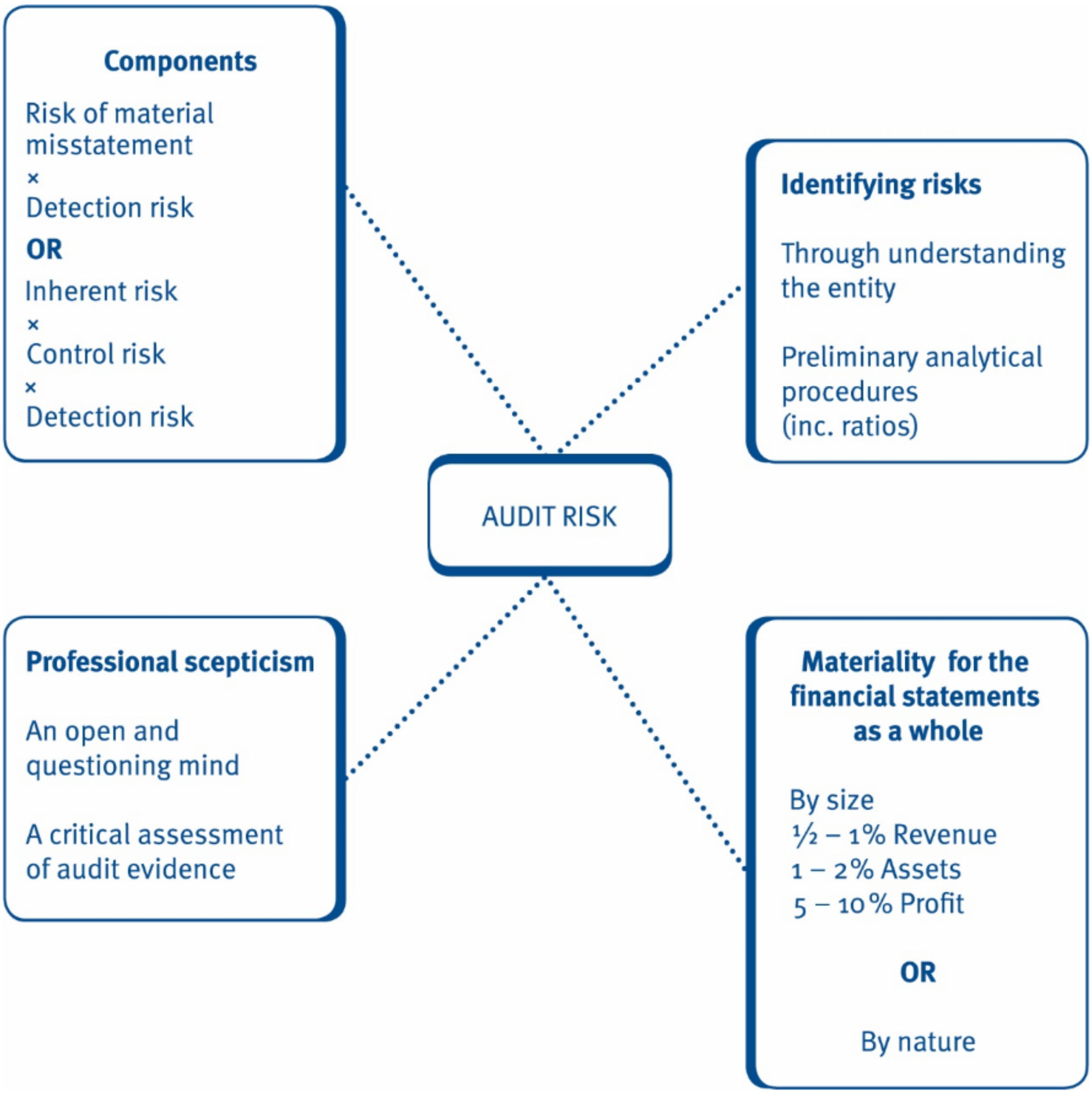
A A critical evaluation of the evidence

B An open and questioning mind

C The auditor should not believe anything the client tells them

D The auditor must be alert to fraud and error

5 Chapter summary



Test your understanding answers

Test your understanding 1

Audit risks	Auditor's response
Murray Co is a new audit client. There is a lack of cumulative audit knowledge and experience. Detection risk is increased. Opening balances may be misstated as Wimble & Co did not perform the audit last year.	More time and resource will need to be devoted to obtaining an understanding of Murray Co at the start of the audit. More substantive procedures will need to be planned and performed, and larger samples tested in order to lower detection risk. Opening balances will need to be agreed to the prior year signed financial statements. The previous auditor could be contacted to obtain relevant working papers.
Inventory is stored at a third-party warehouse. It may be difficult to obtain sufficient appropriate evidence over the quantity and condition of inventory held. There is increased detection risk over completeness, existence and valuation of inventory.	Additional procedures should be performed to ensure that inventory quantities and condition have been confirmed for both third party and company owned locations, e.g. • Attend the inventory count at the third-party warehouses (if one is to be performed) to review the controls in operation. • Inspect any reports produced by the auditors of third-party warehouses in relation to the adequacy of controls over inventory. • Obtain external confirmation from the third party regarding the quantity and condition of the inventory.

Ergometers take up to one week to manufacture. There is likely to be a material work in progress (WIP) inventory balance at the year end. Determining the value and quantity of WIP is complex. There is a risk of misstatement of WIP inventory.	The percentage of completion basis should be discussed with the client and assessed for reasonableness. The WIP calculation should be agreed to supporting documentation such as purchase invoices for materials and timesheets and payroll records for labour. The overhead calculation should be recalculated and reviewed for any non-production overheads.
Murray Co refurbished the assembly line for the ergometers during the year. Expenditure incurred may have been incorrectly capitalised or incorrectly expensed as repairs. There is a risk that that non-current assets are over or understated.	Review a breakdown of the costs and agree to invoices to assess the nature of the expenditure. Agree asset expenditure to inclusion within the asset register, and agree repairs to expenses in the statement of profit or loss.
There is a new website directly linked to the finance system which records sales automatically. There is increased risk over completeness of income if the system fails to record all sales made on the website. There is a risk that revenue is understated.	Extended controls testing to be performed over the sales cycle. Use test data to confirm that sales entered into the website are automatically transferred to the finance system. Detailed testing to be performed over the completeness of income by tracing orders through to GDNs, sales invoices and into the detailed sales listing.
The website development costs have been capitalised. In order to be capitalised, the costs must meet all of the criteria under IAS ® 38 *Intangible Assets*. Research costs should be expensed rather than capitalised. There is a risk that intangible assets are overstated.	A breakdown of the development expenditure should be reviewed and tested in detail to ensure that only projects which meet the capitalisation criteria are included as an intangible asset, with the balance being expensed.

Retailer sales have fallen dramatically in the last two years. If retailer sales continue to fall and direct consumer sales do not compensate for the loss of retailer revenue, Murray Co may not be able to continue to operate for the foreseeable future. There is a risk that disclosures of material uncertainties relating to going concern may be inadequate.	Perform a detailed going concern review, including: Obtain and review the company's cash flow forecast and evaluate the reasonableness of the assumptions used to understand if management will have sufficient cash. Review the post year-end order book from retailers and post year-end direct consumer sales to assess if the revenue figures in the cash flow are reasonable.
Several of the sales team were made redundant last month as a result of the falling retailer sales. Under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, a redundancy provision will be required for any staff not yet paid at the year end. There is a risk of understated liabilities.	Discuss with management the progress of the redundancy programme. Review post year-end bank statements for any redundancy payments made and agree to the year-end provision.
Some retail customers are struggling to pay their outstanding balances to Murray Co. The balances may be irrecoverable debts that should be written off. There is a risk of overstatement of receivables and understatement of the irrecoverable debt allowance and expense.	Extended post year-end cash receipts testing to assess valuation. Review of the list of aged receivables balances to identify long-outstanding debts. The allowance for receivables should be discussed with management if it is considered inadequate.
Murray Co is planning to list on the stock exchange next year. There is an increased risk of manipulation of the financial statements. There is a risk of overstatement of assets and profits, and understatement of expenses and liabilities.	Increase the level of professional scepticism and be alert to the risks identified in order to achieve a successful listing. Plan and perform procedures to ensure accounting estimates and judgemental areas are reasonable.

Test your understanding 2

Audit risks identified using analytical procedures

Revenue has increased by 12%.	Retailer sales at Murray Co have fallen dramatically in the last two years. The increase in revenue is not consistent with this. Although Murray Co has started selling directly to consumers for the first time this year, it is unlikely that these sales will have compensated for the loss in retailer sales at this early stage. In addition, revenue may be deliberately overstated by Murray Co in order to increase the chances of a successful listing. There is a risk that revenue is overstated.
Gross profit margin has increased from 12.8% (2,500/19,580) to 15.5% (3,400/21,960).	The margins for direct consumer sales are likely to be higher than retailer sales, which may explain this increase. However, the increase could also be caused by overstatement of revenue, as explained above, or understatement of cost of sales due to incomplete recording of costs or overvaluation of closing inventory.
Operating expenses has no movement.	This is unusual given the increase in revenue and cost of sales. There is a risk that the prior year figure has been incorrectly presented in the current year column.
Operating profit margin has increased from 2.5% (488/19,580) to 6.3% (1,388/21,960).	Operating profit margin has increased at a greater rate than gross profit margin. Given that this is the first year of direct consumer sales, the operating profit margin would not be expected to increase significantly, as the level of operating expenses would normally be higher at this early stage. This indicates potential overstatement of revenue and understatement of operating expenses.
The inventory holding period has increased from 28 days (1,300/17,080 × 365) to 41 days (2,109/18,560 × 365).	As sales have increased, this could be because of an increase in demand and therefore the need to hold more inventory. However, as retailer sales at Murray Co have fallen dramatically, there is a risk that some of the inventory is bespoke, and may therefore be obsolete. There is a risk that inventory is overstated.

The trade receivables collection period has increased from 20 days (1,050/19,580 × 365) to 34 days (2,040/21,960 × 365).	Given that website customers pay on ordering, the collection period would be expected to fall. However, some of Murray Co's retail customers are struggling to pay their outstanding balances. Trade receivables may be overstated, and the allowance for doubtful debts understated.
The trade payables payment period has increased from 26 days (1,205/17,080 × 365) to 28 days (1,400/18,560 × 365).	An increase in the payables payment period could be caused by understatement of cost of sales. The increase in gross profit margin also highlighted this as a potential risk.
Current ratio has improved from 1.6:1 to 2.3:1. Quick ratio has improved from 0.71: 1 to 1.14:1.	Murray Co appears to be managing its working capital effectively. However, given the plans to list on the stock exchange next year, this may be indicative of manipulation of the financial statements in order to increase the chances of a successful listing. In addition, Murray Co has increased its long and short-term finance during the year.

Test your understanding 3

Audit risks and effect on audit approach

Risk and explanation	Effect on audit approach
Hook Co is a new audit client. There is a lack of cumulative audit knowledge and experience. Detection risk is increased. Opening balances may be misstated as JPR Edwards & Co did not perform the audit last year.	More time and resource will need to be devoted to obtaining an understanding of Hook Co at the start of the audit. More substantive procedures will need to be planned and performed, and larger samples tested in order to lower detection risk. Opening balances will need to be agreed to the prior year signed financial statements. The previous auditor could be contacted to obtain relevant working papers.

Hook Co is expected to have a material work-in-progress balance at the year end. The calculation and valuation of work in progress is subjective. There is a risk of overstatement of inventory.	Appropriate time should be allocated to attending the inventory count and understanding the inventory valuation process for work in progress. The basis for assessing the percentage of completion of WIP should be discussed with management to ensure it is reasonable. Purchase invoices should be inspected to verify cost; payroll records and job cards should be inspected to verify the labour element of WIP and finished goods. Overheads included in WIP and finished goods should be recalculated and reviewed to ensure only production overheads are included.
Hook Co manufactures electrical goods for the entertainment market. This is a rapidly changing market and goods can become obsolete quickly which may result in the NRV falling below cost. There is a risk of overstatement of inventory.	The aged inventory listing should be reviewed for old or obsolete items and compared with the allowance made to write the inventory down to NRV, to ensure the allowance is adequate. If the allowance does not appear adequate, it should be discussed with management.
Hook Co's key client represents 70% of its revenue. Hook Co may be over reliant on this client which could threaten its going concern status if this key client was lost. There is a risk that disclosures of material uncertainties relating to going concern are inadequate.	Procedures should be designed at the planning stage to allow the auditor to assess the going concern risk faced by Hook Co. Contracts and other correspondence from the key customer should be reviewed to identify any specific risks that the client may be lost. Analytical procedures should be designed to assess the impact on Hook Co's financial position if the contract is not renewed.

Hook Co spent $1m on developing a new product. There is a risk that Hook Co has capitalised development expenditure which should have been expensed through the statement of profit or loss as research costs. If the application does not meet the criteria required to classify as development costs they should be expensed to the statement of profit or loss in the year they were incurred. There is a risk of overstatement of intangible assets.	Enquiries should be made as to how Hook Co identifies whether the criteria for capitalisation have been met in accordance with the relevant accounting standard. Where amounts have been capitalised, further procedures should be performed to assess whether the criteria of IAS 38 have been met e.g. review budgets to ensure resources have been allocated to the development, review project plans to ensure the development is expected to be completed, and review forecasts to ensure the product is expected to generate a profit.
Hook Co is aiming to list on the London Stock Exchange this year. The directors may have greater incentive to 'window dress' the accounts to show a more favourable position in order to increase the proceeds generated. Assets and profits may be overstated and liabilities understated to make the company appear a more attractive investment.	Increased professional scepticism is required when performing the audit. Procedures should be planned to ensure areas of judgement and estimates exercised by the directors are reasonable and can be justified. Special consideration should be given to sales cut-off testing.

Test your understanding 4

Materiality is defined as follows:

'Misstatements, including omissions, are considered to be material if they, individually or in aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.' [ISA 320 *Materiality in Planning and Performing an Audit*, 2]

In assessing the level of materiality there are a number of areas that should be considered. Firstly, the auditor must consider both the amount (quantity) and the nature (quality) of any misstatements, or a combination of both. The quantity of the misstatement refers to the relative size of it and the quality refers to an amount that might be low in value but due to its prominence could influence the user's decision, for example, directors' transactions.

The assessment of what is material is ultimately a matter of the auditors' professional judgement, and it is affected by the auditor's perception of the financial information needs of users of the financial statements.

Materiality is often calculated using benchmarks such as 5% of profit before tax or 1% of assets. These values are useful as a starting point for assessing materiality.

In assessing materiality, the auditor must consider that a number of errors each with a low value may, when aggregated, amount to a material misstatement.

In calculating materiality, the auditor should also consider setting the performance materiality level. This is the amount set by the auditor, below materiality for the financial statements as a whole, and is used for particular transactions, account balances and disclosures.

Test your understanding 5

1	D	Options A, B and C are business risks. An audit risk must be described in terms of a risk of material misstatement (i.e. the impact on the financial statements) or a detection risk (why the auditor may not detect the misstatement).
2	A	Payables/Cost of sales × 304. There are 304 days in the period January to October.
3	B	Recalculation is not an analytical procedure. An analytical procedure evaluates relationships between data.
4	D	Revenue growth is a trend rather than a ratio. Acid test is another name for the quick ratio.
5	C	If closing inventory is overvalued, a larger figure will be deducted from cost of sales and, therefore, cost of sales will be lower and gross profit will be higher. A and B would both cause gross profit margin to fall. D would have no impact as administrative expenses do not affect gross profit.

Test your understanding 6

1	B	The financial statements can be materially misstated by the omission of a balance or disclosure.
2	C	External confirmation is not listed in ISA 315 (Revised 2019) as a risk assessment procedure. It is usually used as a substantive procedure.
3	A	Using 5% of PBT and 1% of total assets an appropriate level of materiality would be $150,000 for the statement of profit or loss and $500,000 for the statement of financial position.
4	D	A and B both refer to tolerable misstatement. C is a description of materiality for the financial statements as a whole.
5	C	Professional scepticism involves being alert to possible frauds and errors but does not require complete mistrust of the client.

Chapter

6

Planning

Chapter learning objectives

This chapter covers syllabus areas:

- B1e – Explain the overall objectives and importance of quality management procedures in conducting an audit
- B1f – Explain the quality management procedures over engagement resources, engagement performance, monitoring and remediation and compliance with ethical requirements
- B1g – Evaluate quality management deficiencies and provide recommendations to allow compliance with quality management requirements
- B2 – Planning and risk assessment: objective and general principles
- B5 – Fraud, laws and regulations
- B6 – Audit planning and documentation

Detailed syllabus objectives are provided in the introduction section of the text book.

PER

One of the PER performance objectives (PO18) is to prepare for and plan the audit process. You plan and control the engagement process, including the initial investigation. You also plan and monitor the audit programme – legally and ethically. Working through this chapter should help you understand how to demonstrate that objective.

1 Purpose of planning

'The objective of the auditor is to plan the audit so that it will be performed in an effective manner.'
[ISA 300 *Planning an Audit of Financial Statements*, 4]

Audits are potentially complex, risky and expensive processes. Although firms have internal manuals and standardised procedures, it is vital that engagements are planned.

Benefits of planning

Planning enables the auditor to:

- Devote appropriate attention to important areas of the audit.
- Identify and resolve potential problems on a timely basis.
- Organise and manage the audit so that it is performed in an effective and efficient manner.
- Select team members with appropriate capabilities and competencies.
- Direct and supervise the team and review their work.
- Effectively coordinate the work of others, such as experts and internal audit.

[ISA 300, 2]

Planning ensures that the risk of performing a poor quality audit (and ultimately giving an inappropriate audit opinion) is reduced to an acceptable level.

Conducting the audit in accordance with ISAs:

In order to achieve the overall objectives of the auditor, the audit must be conducted in accordance with ISAs. This will:

- Ensure that the auditor is fulfilling all of their responsibilities.
- Allow a user to have as much confidence in one auditor's opinion as another's and therefore to rely on one audited set of financial statements to the same extent that they rely on another.
- Ensure that the quality of audits internationally, is maintained to a high standard (thereby upholding the reputation of the profession).
- Provide a measure to assess the standard of an auditor's work (necessary when determining their suitability as an authorised practitioner).

Professional scepticism and professional judgement

Auditors are also required to perform audits with an attitude of professional scepticism. Professional scepticism was explained in the previous chapter. Having an enquiring mind in itself is not sufficient to comply with a risk based method of auditing, the auditor must also use professional judgement.

Professional judgement is **the application of relevant training, knowledge and experience in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement**.
[ISA 200, 13k]

Therefore, the use of a risk based approach requires skill, knowledge, experience and an inquisitive, open mind.

Although risk assessment is a fundamental element of the planning process, risks can be uncovered at any stage of the audit, and procedures must be adapted in light of revelations that indicate further risks of material misstatement. It is the responsibility of the most senior reviewer (usually the engagement partner) to confirm that this happens.

The planning process

Planning consists of a number of elements. They can be summarised as:

- Preliminary engagement activities:
  - Performing procedures regarding the acceptance and continuance of the client relationship and audit engagement.
  - Evaluating compliance with ethical requirements.
  - Ensuring there are no misunderstandings with the client as to the terms of the engagement.

  [ISA 300, 6]

  The preliminary engagement activities were covered in the chapter Ethics and acceptance.

- Planning activities:
  - Developing the audit strategy
  - Developing an audit plan.

  [ISA 300, 7]

The audit strategy and the audit plan must be documented in the audit working papers. Any updates to them must also be documented.

2 The audit strategy

The audit strategy sets the scope, timing and direction of the audit.

The diagram below summarises some of the matters the auditor may consider in establishing the strategy.

[ISA 300, Appendix]

The audit strategy allows the auditor to determine:

- The nature of resources (human, technological or intellectual) to be deployed for specific audit areas (e.g. experienced team members, experts).
- The amount of resources to be allocated (i.e. number of team members).
- When these resources are to be deployed.
- How the resources are directed and supervised, including the timings of meetings, debriefs and manager reviews.

[ISA 300, A8]

3 The audit plan

Once the audit strategy has been established, the next stage is to develop a specific, detailed plan to address how the various matters identified in the overall strategy will be applied.

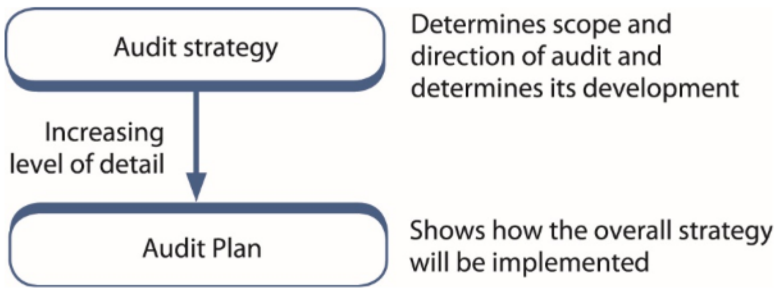
The strategy sets the overall approach to the audit and the plan fills in the operational details of how the strategy is to be achieved.

The audit plan should include specific descriptions of:

- The nature, timing and extent of the planned direction and supervision of engagement team members and the review of their work.
- The nature, timing and extent of risk assessment procedures.
- The nature, timing and extent of further audit procedures, including:
  - **What** audit procedures are to be carried out
  - **Who** should do them
  - **How** much work should be done (sample sizes, etc.)
  - **When** the work should be done (interim vs. final)
- Any other procedures necessary to conform to ISAs.

[ISA 300, 9]

The relationship between the audit strategy and the audit plan



4 Interim and final audit

The auditor must consider the timing of audit procedures such as whether to carry out an interim audit and a final audit, or just a final audit.

For an interim audit to be justified, the client normally needs to be of a sufficient size because this may increase costs. However, an interim audit should improve risk assessment and make final procedures more efficient.

It is important to note that the interim audit and final audit are two stages of the same audit. One set of financial statements are audited. One auditor's report will be issued. The audit work however is being performed in two stages – some work before the year end and some work after the year end.

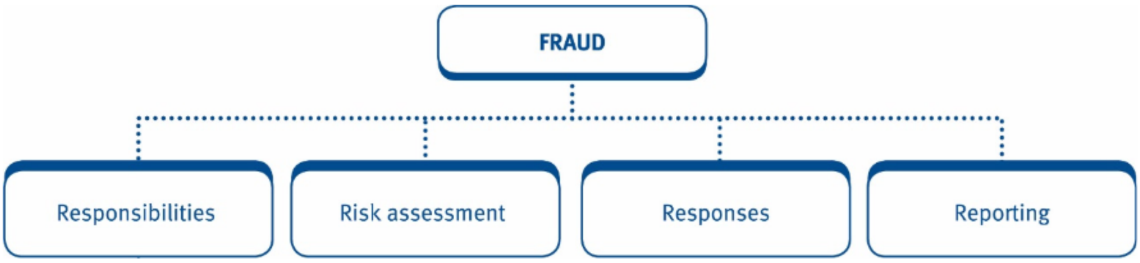
	Interim audit	**Final audit**
Timing	Completed part way through a client's accounting year (i.e. before the year end). Early enough not to interfere with year-end procedures at the client and to give adequate warning of specific problems that need to be addressed in planning the final audit. Late enough to enable sufficient work to be done to ease the pressure on the final audit.	Takes place after the year end at a time agreed with the client which enables them to file their financial statements with the relevant authorities by the required deadline. Generally, a client would not want the auditor to be performing the audit at the year end as this will cause disruption for the client's year-end procedures.
Purpose	Allows the auditor to spread out their procedures and enables more effective planning for the final stage of the audit. Useful when there is increased detection risk due to a tight reporting deadline.	To obtain sufficient appropriate evidence in respect of the financial statements to enable the auditor's report to be issued. The auditor's report will be issued once the final audit is complete and this signifies the end of the audit.

Work performed	• Documenting systems • Evaluating controls. Additional activities that can be performed include: • Testing of specific and complete material transactions, e.g. purchasing new non-current assets. • Testing of transactions such as sales, purchases and payroll for the year to date. • Assessing risks that will affect work conducted at the final audit. • Attending perpetual inventory counts.	• Audit of statement of financial position balances which will only be known at the year end. • Transaction testing for transactions that have occurred since the interim audit took place. • Testing of year-end journals, which may include adjustments to the transactions tested at the interim audit. • Obtaining evidence that the controls tested at the interim audit have continued to operate during the period since the interim audit took place. • Completion activities such as going concern and subsequent events reviews, overall review of the financial statements and communication of misstatements with management and those charged with governance.

Impact of interim audit work on the final audit

- If the controls tested at the interim stage provided evidence that control risk is low, fewer substantive procedures can be performed.
- If substantive procedures have been performed at the interim stage, fewer procedures will be required at the final audit in general. This will mean the final audit will require less time to perform.
- The auditor's report can be signed closer to the year end resulting in more timely reporting to shareholders.
- If the interim audit identified areas of increased risk, for example, controls were found not to be working effectively, increased substantive procedures will be required at the final audit.

5 Fraud and error



Misstatement in the financial statements can arise from either fraud or error. The distinguishing factor is whether the underlying action that resulted in the misstatement was intentional or unintentional. [ISA 240, 2]

Fraud

Fraud is **an intentional act by one or more individuals among management, those charged with governance, employees or third parties, involving the use of deception to obtain an unjust or illegal advantage**.
[ISA 240 *the Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, 11a]

Fraud can be split into two types:

- Fraudulent financial reporting – deliberately misstating the financial statements to make the company's performance or position look better/worse than it actually is.
- Misappropriation – theft of a company's assets such as cash or inventory.

[ISA 240, 3]

Error

An error can be defined as an unintentional misstatement in financial statements, including the omission of amounts or disclosures, such as the following:

- A mistake in gathering and processing data from which financial statements are prepared.
- An incorrect accounting estimate arising from oversight or a misinterpretation of facts.
- A mistake in the application of accounting principles relating to measurement, recognition, classification, presentation or disclosure.

[ISA 450 *Evaluation of Misstatements Identified During the Audit*, A1]

Directors' responsibilities in respect of fraud

The primary responsibility for the prevention and detection of fraud rests with those charged with governance and the management of an entity.

This is achieved by:

- Implementing an **effective system of internal control,** reducing opportunities for fraud to take place and increasing the likelihood of detection (and punishment).
- Creating a **culture** of honesty, ethical behaviour, and active oversight by those charged with governance.

The directors should be aware of the potential for fraud and this should feature as an element of their risk assessment and corporate governance procedures.

The audit committee should review these procedures to ensure that they are in place and working effectively.

This will normally be achieved in conjunction with the internal auditors.

[ISA 240, 4]

Internal auditors

Internal auditors can help management fulfil their responsibilities in respect of fraud and error. Typical functions the internal auditor can perform include:

- Testing the effectiveness of the internal controls at preventing and detecting fraud and error and provide recommendations for improvements to the controls.
- Performing fraud investigations to:
  - identify how the fraud was committed
  - identify the extent of the fraud
  - provide recommendations on how to prevent the fraud from happening again.
- Performing surprise asset counts to identify misappropriation.

The presence of an internal audit department may act as a deterrent to fraud in itself as there is a greater chance of being discovered.

External auditor's responsibilities in respect of fraud

The auditor's role is two-fold:

- Assess the risk of material misstatement due to fraud, and
- Respond to the assessed risks.

Assessing the risk of fraud

The auditor should:

- Obtain reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. [ISA 240, 5]
- Apply professional scepticism and remain alert to the possibility that fraud could take place. [ISA 240, 8]

This means that the auditor must recognise the possibility that a material misstatement due to fraud could occur, regardless of the auditor's prior experience of the client's integrity and honesty.

- Consider the potential for management override of controls and recognise that audit procedures that are effective for detecting error may not be effective for detecting fraud. [ISA 240, 8]

This can be achieved by performing the following procedures:

- Discuss the susceptibility of the client's financial statements to material misstatement due to fraud with the engagement team. [ISA 240, 15]

  This discussion should include consideration of:

  – Incentives to commit fraud such as profit related bonuses or applications for finance.

  – Opportunities to commit fraud such as ineffective internal controls.

  – Management's attitude e.g. disputes with the auditor over auditing matters or failure to remedy known deficiencies.

  [ISA 240, Appendix 1]

- Enquire of management about their processes for identifying and responding to the risk of fraud. [ISA 240, 17]

- Enquire of management, internal auditors and those charged with governance if they are aware of any actual or suspected fraudulent activity. [ISA 240, 18 – 21]

- Consideration of relationships identified during analytical procedures. [ISA 240, 22]

Responding to the assessed risks

The following procedures must be performed:

- Review journal entries made to identify manipulation of figures recorded or unauthorised journal adjustments:

  – Enquire of those involved in financial reporting about unusual activity relating to adjustments.

  – Select journal entries and adjustments made at the end of the reporting period.

  – Consider the need to test journal entries throughout the period. [ISA 240, 32a]

- Review management estimates for evidence of bias:

  – Evaluate the reasonableness of judgements and whether they indicate any bias on behalf of management.

  – Perform a retrospective review of management judgements reflected in the prior year.
  [ISA 240, 32b]

- Review transactions outside the normal course of business, or transactions which appear unusual and assess whether they are indicative of fraudulent financial reporting.
  [ISA 240, 32c]
- Obtain written representation from management and those charged with governance that they:
  - acknowledge their responsibility for internal controls to prevent and detect fraud.
  - have disclosed to the auditor the results of management's fraud risk assessment.
  - have disclosed to the auditor any known or suspected frauds.
  - have disclosed to the auditor any allegations of fraud affecting the entity's financial statements.
    [ISA 240, 39]

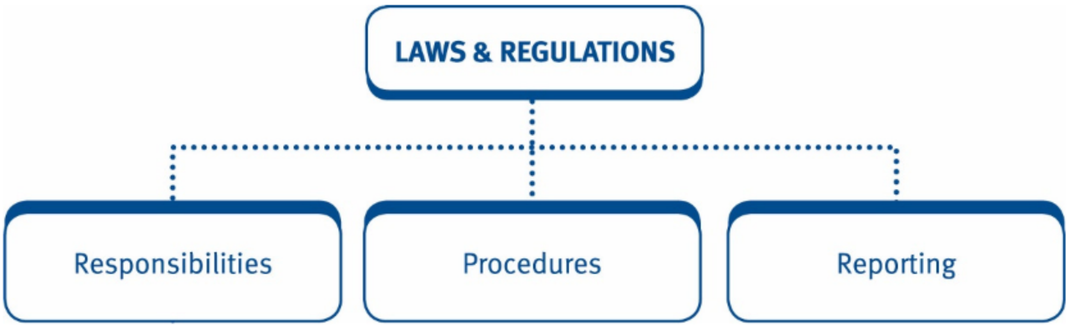
There is an unavoidable risk that some material misstatements may not be detected even if properly planned in accordance with ISAs as fraud is likely to be concealed. [ISA 240, 5]

The ability to detect fraud depends on the skill of the perpetrator, collusion, relative size of amounts manipulated, and the seniority of the people involved. [ISA 240, 6]

Reporting of fraud and error

- If the auditor identifies a fraud they must communicate the matter on a timely basis to the appropriate level of management (i.e. those with the primary responsibility for prevention and detection of fraud). [ISA 240, 40]
- If the suspected fraud involves management, the auditor must communicate the matter to those charged with governance. [ISA 240, 41]
- If the auditor has doubts about the integrity of those charged with governance they should seek legal advice regarding an appropriate course of action. [ISA 240, A65]
- In addition to these responsibilities, the auditor must also consider whether they have a responsibility to report the occurrence of a suspicion to a party outside the entity. Whilst the auditor does have an ethical duty to maintain confidentiality, it is likely that any legal responsibility will take precedence. In these circumstances it is advisable to seek legal advice. [ISA 240, 43]
- If the fraud has a material impact on the financial statements the audit opinion will be modified. When the opinion is modified, the auditor will explain why it has been modified and this will make the shareholders aware of the fraud.

6 Laws and regulations



Guidance relating to laws and regulations in an audit of financial statements is provided in ISA 250 (Revised) *Consideration of Laws and Regulations in an Audit of Financial Statements.*

Non-compliance – **Acts of omission or commission, either intentional or unintentional, committed by the entity, which are contrary to the prevailing laws or regulations. Non-compliance does not include personal misconduct unrelated to the business activities of the entity**.
[ISA 250, 12]

Responsibilities of management

It is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with relevant laws and regulations, including those that determine the reported amounts and disclosures in the financial statements. [ISA 250, 3]

Responsibilities of the auditor

The auditor must perform audit procedures to help identify non-compliance with laws and regulations that may have a material impact on the financial statements.

The auditor must obtain sufficient, appropriate evidence regarding compliance with laws and regulations generally recognised to have a **direct effect** on the determination of material amounts and disclosures in the financial statements (e.g. completeness of a tax provision in accordance with tax law, or the presentation of the financial statements in accordance with the applicable financial reporting framework). [ISA 250, 6a]

The auditor must perform audit procedures to help identify non-compliance with **other laws and regulations** that may have a material impact on the financial statements (e.g. data protection, environmental legislation, public health and safety). Non-compliance in respect of such matters could affect the company's ability to continue as a going concern or could result in the need for material liabilities to be recognised or disclosed. [ISA 250, 6b]

Audit procedures to identify instances of non-compliance

- **Obtaining a general understanding** of the legal and regulatory framework applicable to the entity and the industry, and of how the entity is complying with that framework. [ISA 250, 13]
- **Enquiring of management and those charged with governance** as to whether the entity is in compliance with such laws and regulations. [ISA 250, 15a]
- **Inspecting correspondence** with relevant licensing or regulatory authorities. [ISA 250, 15b]
- **Remaining alert** to the possibility that other audit procedures applied may bring instances of non-compliance to the auditor's attention. [ISA 250, 16]
- **Obtaining written representation** from the directors that they have disclosed to the auditors all those events of which they are aware which involve possible non-compliance, together with the actual or contingent consequences which may arise from such non-compliance. [ISA 250, 17]

Investigations of possible non-compliance

When the auditor becomes aware of information concerning a possible instance of **non-compliance** with laws or regulations, they should:

- Understand the **nature of the act and circumstances** in which it has occurred.
- Obtain further information to **evaluate the possible effect** on the financial statements.

[ISA 250, 19]

Audit procedures when non-compliance is identified

- Enquire of management of the penalties to be imposed.
- Inspect correspondence with the regulatory authority to identify the consequences.
- Inspect board minutes for management's discussion on actions to be taken regarding the non-compliance.
- Enquire of the company's legal department as to the possible impact of the non-compliance.

Reporting non-compliance

- The auditor must report non-compliance to management and those charged with governance, unless prohibited by law or regulation. [ISA 250, 23]
- If the auditor believes the non-compliance is intentional and material, the matter should be reported to those charged with governance. [ISA 250, 24]
- If the auditor suspects management or those charged with governance are involved in the non-compliance, the matter should be reported to the audit committee or supervisory board. [ISA 250, 25]
- If the non-compliance has a material effect on the financial statements, a qualified or adverse opinion should be issued. [ISA 250, 26]
- The auditor should also consider whether they have any legal or ethical responsibility to report non-compliance to third parties (e.g. to a regulatory authority). [ISA 250, 29]

Responding to Non-compliance with Laws and Regulations

Ethical guidance on the professional accountant's responsibilities when non-compliance with laws and regulations (NOCLAR) is identified or suspected is set out in Section 260 of the ACCA Code of Ethics and Conduct.

The additional requirements have been introduced to address concerns that the duty of confidentiality was acting as a barrier to the disclosure of potential non-compliance to public authorities in the appropriate circumstances. Accountants were resigning from client relationships without issues being appropriately addressed.

Professional accountants must act in the public interest, therefore when responding to non-compliance or suspected non-compliance, the auditor must:

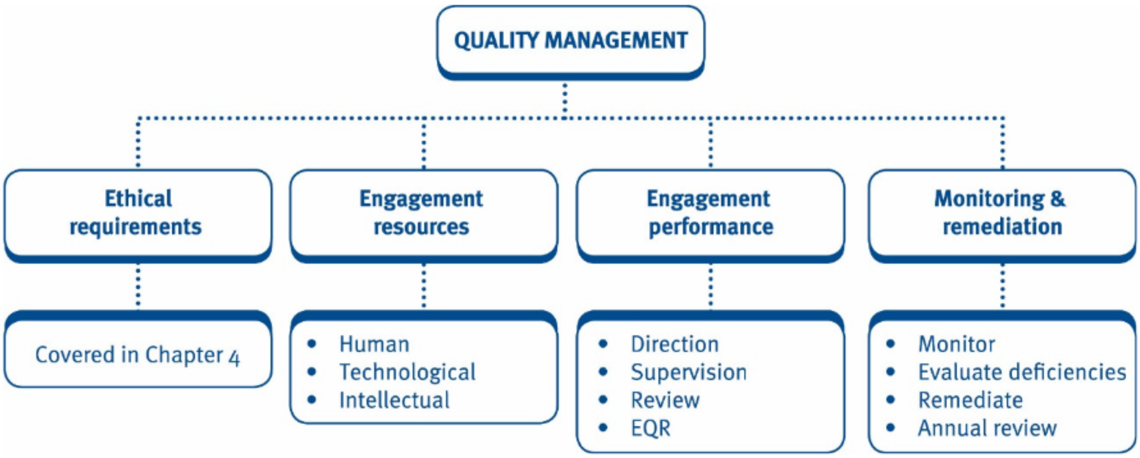
- Comply with the principles of integrity and professional behaviour.
- Alert management or those charged with governance of the non-compliance to enable them to rectify or mitigate the consequences, or deter the non-compliance if it has not yet occurred.
- Take further action as appropriate in the public interest.

The aim is to generate an earlier response by management or those charged with governance, and timelier intervention from public authorities on reports of potential non-compliance, thereby mitigating adverse consequences for stakeholders and the general public.

The following matters must be documented:

- The matter.
- The results of discussions with management and those charged with governance.
- How the accountant's superior has responded to the matter.
- The courses of action considered, judgements made and decisions taken.

7 Quality management



ISA 220 (Revised) *Quality Management for an Audit of Financial Statements* requires the firm to design, implement and operate a system of quality management that provides reasonable assurance that the firm:

- conducts engagements in accordance with professional standards and applicable legal and regulatory requirements, and
- issues reports that are appropriate in the circumstances. [ISA 220 (Revised), 2]

Policies and procedures should be established which address:

- Leadership responsibilities for managing and achieving quality on audits
- Relevant ethical requirements
- Acceptance and continuance of client relationships and audit engagements
- Engagement resources
- Engagement performance
- Monitoring and remediation
- Taking overall responsibility for managing and achieving quality
- Documentation

The Audit and Assurance syllabus requires an understanding of the relevant ethical requirements, engagement resources, engagement performance and monitoring and remediation.

ISA 220 (Revised)

ISA 220 (Revised) aims to address public interest concerns about audit quality by:

- Encouraging proactive management of quality at the engagement level.
- Emphasising the importance of the exercise of professional scepticism.
- Enhancing the documentation of the auditor's judgements.
- Keeping the standard fit for purpose in a wide range of circumstances and in a complex environment.

Relevant ethical requirements

The firm should ensure compliance with the requirements of the ACCA Code of Ethics and Conduct covered in the chapter 'Ethics and acceptance'.

The engagement partner must:

- Identify, evaluate and address ethical threats.
- Remain alert throughout the audit for breaches of ethical requirements.
- Take appropriate action where ethical requirements have not been fulfilled.
- Prior to dating the auditor's report, take responsibility for determining whether ethical requirements have been fulfilled.

[ISA 220 (Revised), 17, 19, 20, 21]

Engagement resources

The engagement partner must ensure sufficient and appropriate resources are assigned or made available to the engagement team. [ISA 220 (Revised), 25]

Engagement resources include:

- Human resources
- Technological resources
- Intellectual resources

Human resources

The engagement team, auditor's external experts and internal auditors who provide direct assistance must be competent and capable to perform the audit. [ISA 220 (Revised), 26]